

JOURNAL OF ACCOUNTANCY

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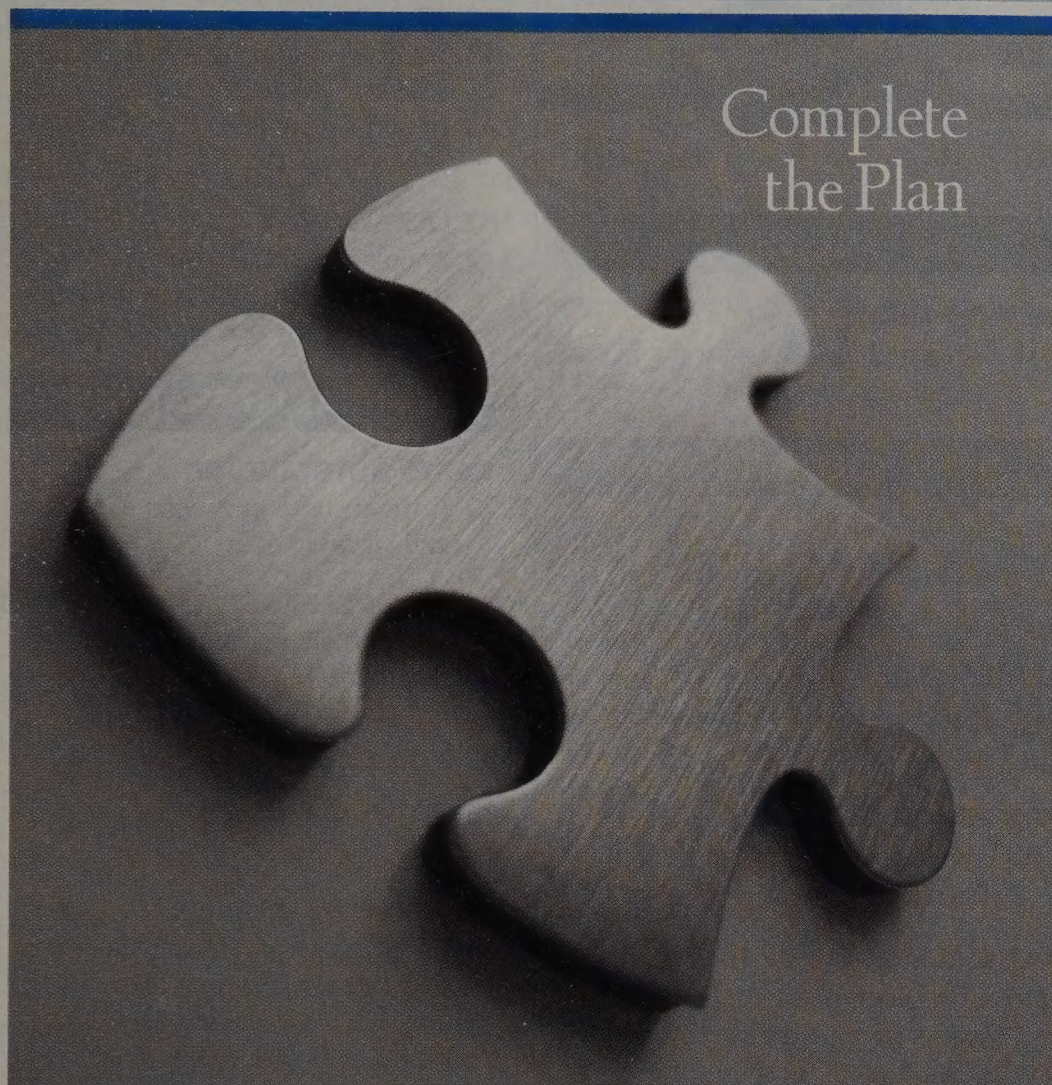
MARCH 2011

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www.journalofaccountancy.com

Issue 3

Complete the Plan



22 | BUSINESS & INDUSTRY

Scenario Planning: Navigating Through Today's Uncertain World

by David A.J. Axson

Scenario planning is a way of understanding forces such as demographics, globalization, technological change and environmental sustainability that will shape the future, and harnessing them to plan for risk. This article, based on an AICPA-sponsored Management Accounting Guideline, introduces the types of scenarios you should consider and provides tips for getting started with scenario planning.

► For CPAs in business and industry

28 | TAX / BUSINESS & INDUSTRY

Act 2 for Business Tax Incentives

by Douglas M. Sayuk, CPA; Matthew H. Fricke; and Shamen R. Dugger, Esq., CPA

A brace of recently enacted laws gives businesses a lot to applaud, especially if those businesses can combine certain provisions. Here are some of the most beneficial strategies, with accounting treatment for companies of several profiles of profitability and loss.

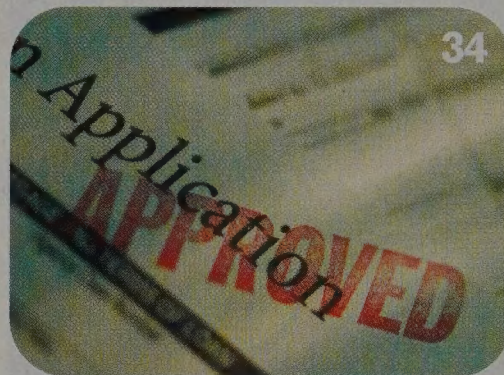

► For CPAs who advise business on taxes and accounting

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How to Land an SBA Loan

by Ron Box, CPA/CITP/CFF

Many businesses may be taking a fresh (or first) look at U.S. Small Business Administration-backed loans since conventional credit remains tight. Get the basics on the most common SBA programs and what's involved in securing the funding.

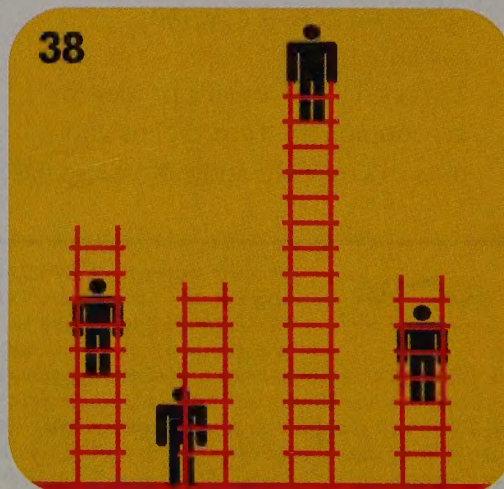

► For CPAs in business and industry and those advising small businesses 

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Corporate Finance Salary Outlook

by Connie R. Gentry

Get benchmarking data to compare base pay for corporate finance jobs in your organization, and read about the positions with the biggest projected pay gains in this analysis of salaries and the job market.

► For CPAs in business and industry 

ARTICLES

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LinkedIn Tips for CPAs

by Robin M. Hensley

Whether in the hands of a sole practitioner or as a strategy for a large CPA firm, LinkedIn can be a useful tool for accountants to grow their business and stay on top of industry trends. This article provides tips and examples from firms that have achieved success using this social media outlet.

► For all CPAs, especially those in public practice



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48 | PRACTICE MANAGEMENT / TECHNOLOGY

Are You Linked In?: An Introduction to the Social Media Tool

by Caroline O. Ford, CPA, Ph.D., and Justin Lim

This article serves as a primer for accountants to learn the ins and outs of LinkedIn and can be used as

an additional resource on how to benefit from using LinkedIn from a business perspective.

► For all CPAs, especially those in public practice



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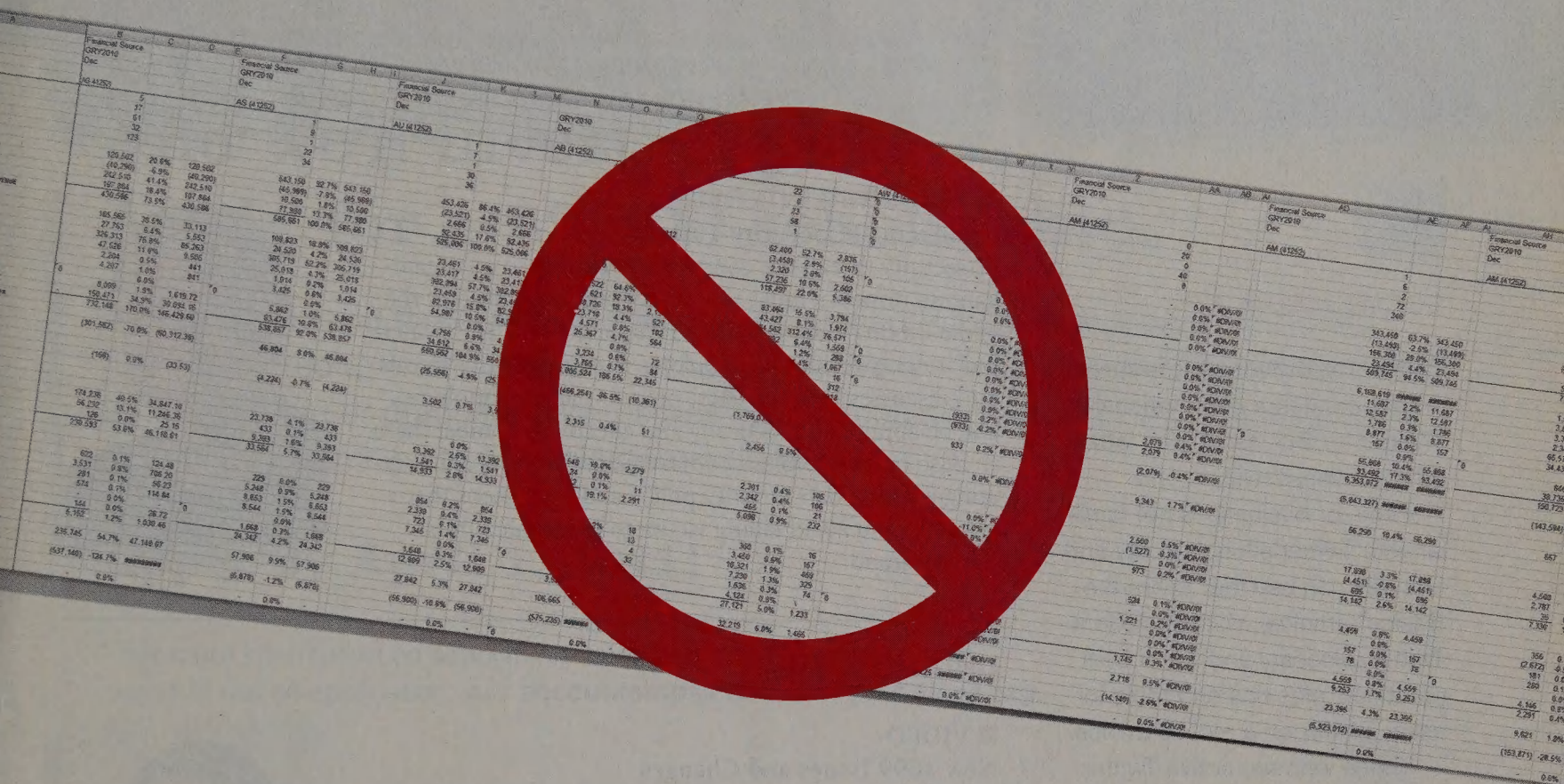
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Firms or businesses not familiar with Twitter's functionality and features can use the "Learn the Basics" articles, which include a Twitter Glossary and list of best practices, plus tips and tools for using Twitter on a mobile device.

Those who are active Twitter users or are familiar with its features and functionality will find the "Optimize Your Activity" section helpful. It includes case studies on customer service, building community and engaging customers, as well as information on widgets and API integration.

There is also a new "Twitter for Business" feed, which posts helpful tips and news for businesses, community groups, organizations and schools. To follow @TwitterBusiness, sign in to your Twitter account and visit twitter.com/twitterbusiness, then click "Follow."

For more social media tips, visit facebook.com/JournalofAccountancy and click the "Tips" tab.

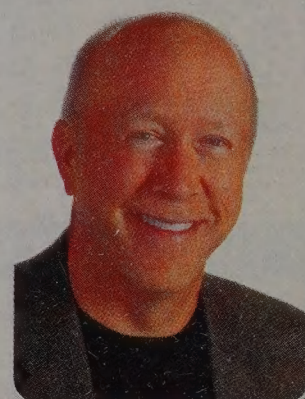
—By **Megan Pinkston** (mpinkston@aicpa.org), the JofA's senior online editor.

FEATURED INTERVIEW

Combating IT Security Threats

IT security threats are constantly evolving, so an organization's response must also evolve and stay ahead of the game. In this interview, David Cieslak, CPA/CITP, principal at Arxis Technology, explores current security threats and discusses how the latest products and technologies can be applied to practically and effectively combat them.

Also on journalofaccountancy.com, read tips for creating a strong data security policy and learn steps that can help you avoid falling victim to electronic funds transfer fraud.



ONLINE EXTRAS

VIDEO

New 1099 Issues and Changes

In this installment of the "Washington Update" video series, Edward Karl, CPA, vice president—Taxation at the AICPA, discusses recent developments concerning rules for IRS Form 1099-MISC.



ARTICLE

Save Time and Trouble With General Asset Accounts

This how-to article by Gregory L. Buhrow, CPA, MBA, provides discussion, a case study and an interactive spreadsheet for weighing the pros and cons of this special depreciation election.

ARTICLE

The 20 Most Popular Stories of 2010

Use this list of 2010's most popular JofA articles to catch up on important news you may have missed in the past year. It includes the Top 10 most-read articles from the JofA's monthly print edition, plus the Top 10 most popular online-only news articles posted exclusively on journalofaccountancy.com in 2010.



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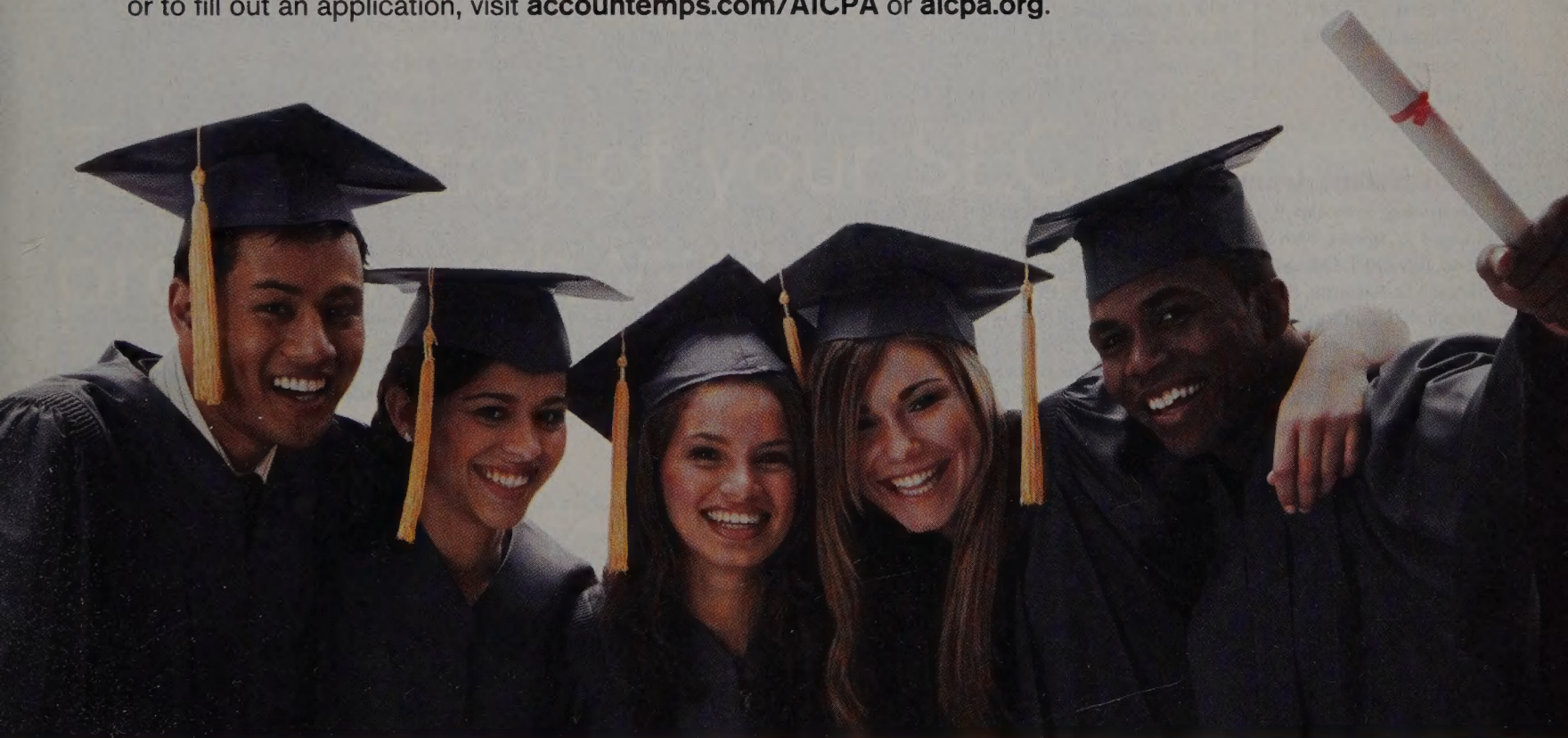
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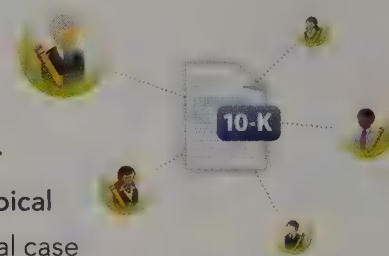
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Contributing AUTHORS

■ Scenario Planning: Navigating Through Today's Uncertain World page 22



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■ Act 2 for Business Tax Incentives page 28



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■ How to Land an SBA Loan page 34



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■ Corporate Finance Salary Outlook page 38



Connie R. Gentry is a communications consultant and a contributing editor for a number of organizations and publishers. In addition to writing for business publications such as the *JofA*, she is a corporate communications consultant for a Boston-based global finance firm and a strategic account director for a public relations firm in North Carolina's Research Triangle Park. Additionally, she contributes editorial content to a retail news magazine, covering all aspects of the corporate retail enterprise including finance.

(Continued on page 12)



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(Continued from page 10)

■ **LinkedIn Tips for CPAs** page 44



Robin M. Hensley is a business development coach. She is founder and president of Raising the Bar, a coaching company focused on developing high-achieving lawyers, CPAs and other professional service providers. She is author of *Raising the Bar: Legendary Rainmakers Share Their Business Development Secrets*. She is a director and the audit committee chair for Superior Uniform Group, a company listed on NASDAQ. She was on the audit and consulting staff with Ernst & Young; and served in marketing and business development positions with the Atlanta law firms Kilpatrick Stockton and Swift, Currie, McGhee & Hiers.

■ **Are You Linked In?: An Introduction to the Social Media Tool** page 48



Caroline O. Ford, CPA, Ph.D., is an assistant professor of accounting at Baylor University, where she teaches accounting research and communication to undergraduate accounting majors. She specializes in behavioral accounting research with emphasis on auditor judgment and decision making. She has written previously (with C. William Thomas) in the *JofA* on the FASB Accounting Standards Codification ("Test-Driving the Codification," Dec. 2008, page 62).



Justin Lim is a master of taxation graduate student at Baylor University. He will intern with UHY Advisors during the spring 2011 tax season and plans to graduate in summer 2011.



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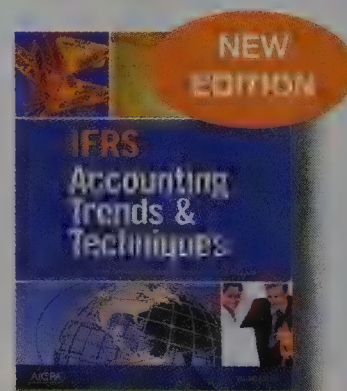
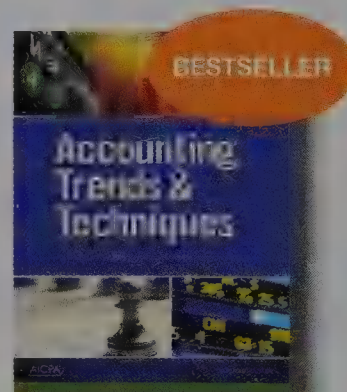
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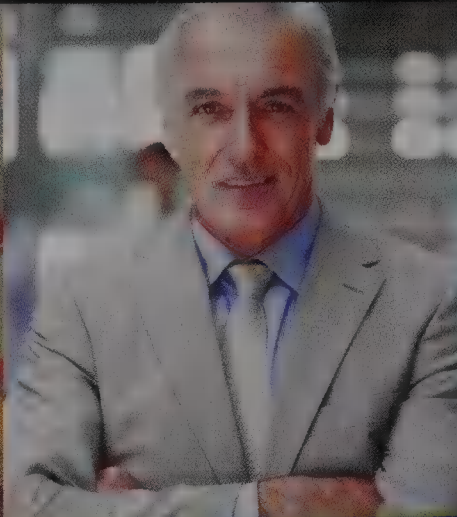
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AUDITING

■ The PCAOB proposed for public comment a temporary rule to establish an interim inspection program for registered public accounting firms' audits of brokers and dealers, while the board considers the scope and other elements of a permanent inspection program, consistent with the Dodd-Frank Wall Street Reform and Consumer Protection Act. The board also proposed rules related to assessing and collecting a portion of its accounting support fee from brokers and dealers to fund PCAOB oversight of the audits. Certain amendments to existing funding rules for issuers were also proposed for public comment.

Under the temporary rule, the board would begin to inspect auditors of brokers and dealers and identify and address with the registered firms any significant issues in those audits. The board said in its press release that it expects insights gained through the interim program to inform the eventual determination of the scope and elements of a permanent program. The board said it expects to propose rules for a permanent program after no more than two years of an interim program. While the interim program is in place, the board said it would at least annually provide public reports on the program's progress and significant issues identified, but that it would not expect to issue firm-specific inspection reports before the scope of a permanent program is set.

The proposed temporary rule says it would not change anything about the rules or standards that govern audits of broker-dealers. The PCAOB said that, as the SEC has previously explained, its rules continue to require those audits to be carried out under GAAS (generally accepted auditing standards).

HIGHLIGHTS

■ Following years of advocacy efforts and a legal battle, CPAs received a permanent exemption from the Federal Trade Commission's Red Flags Rule with President Barack Obama's December signing of the Red Flag Program Clarification Act of 2010.

The Red Flags Rule, which was released Nov. 9, 2007, under the Fair and Accurate Credit Transactions Act of 2003, requires businesses and organizations within its scope to implement a written identity theft prevention program to detect warning signs of identity theft in their day-to-day operations. Enforcement of the rule has been postponed numerous times—most recently until Dec. 31, 2010—since the original Nov. 1, 2008, effective date.

The rule applies to what it calls "financial institutions" and "creditors." However, according to the FTC website, the definition of "creditor" in the rule is broad, and includes businesses or organizations that regularly provide goods or services first and allow customers to pay later. As examples, the FTC says utilities, health care providers, lawyers, accountants, and other professionals, and telecommunications companies may fall within the definition.

■ **The Social Security Administration issued a final rule that limits beneficiaries' ability to stop their Social Security retirement payments, repay their cumulative past benefits, and start receiving higher payments available to older applicants.** The SSA said the restrictions were necessary to prevent abuse of the option, which has been called the "do-over" (see "Social Security for Two," *JofA*, Jan. 2009, page 30) and to protect the solvency of the Social Security Trust Fund.

Effective Dec. 8, 2010, the date of the final rule (RIN 0960-AH07, docket no. SSA 2009-0073), recipients of retirement benefits may cancel them only once during their lifetimes and only within the first 12 months after they begin receiving

(Continued on page 17)

The board proposed that the accounting support fee be based on "tentative net capital," which, under the SEC's rules, is net capital before deducting certain securities haircuts and charges for certain commodities transactions (according to SEC Rule 15c3-1(c)(15)). Because those deductions depend on types of investments and transactions the broker or dealer may elect to enter during the period, the board said tentative net capital is considered to be a more consistent measure than net capital.

The PCAOB said 4,600 brokers and dealers are registered with the Financial

Industry Regulatory Authority (FINRA). Approximately 86% of FINRA brokers and dealers have tentative net capital of less than \$5 million, and those 86% account for only approximately 1.1% of the industry's total tentative net capital. The remaining 14% of brokers and dealers hold the other 98.9% of the industry's tentative net capital, with only about 33 FINRA brokers and dealers holding approximately 80%. Therefore, the board has proposed that a class of brokers and dealers, each with tentative net capital of less than \$5 million, pay no portion of the

accounting support fee. The board said that this would leave about 640 of 4,600 FINRA-registered brokers and dealers to pay a share of the accounting support fee.

The temporary rule proposal is available at tinyurl.com/32wuuxq; the accounting support fee proposal is available at tinyurl.com/39vjxuv. The comment period closed Feb. 15.

■ The PCAOB has entered into a cooperative agreement with the Professional Oversight Board (POB) in the United Kingdom to facilitate cooperation in the oversight of auditors and public accounting firms that practice in the two regulators' respective jurisdictions.

This agreement provides a basis for the resumption of PCAOB inspections of registered accounting firms that are in the U.K. and that audit, or participate in audits, of companies whose securities trade in U.S. markets. From 2005 to 2008, the PCAOB conducted inspections in the U.K. with the POB, but has been blocked from doing so since then.

This cooperative agreement, which was announced Jan. 10, is the first that the PCAOB concluded since the Dodd-Frank Wall Street Reform and Consumer Protection Act was signed into law by President Barack Obama in July 2010. Dodd-Frank amended the Sarbanes-Oxley Act to permit the PCAOB to share confidential information with its non-U.S. counterparts under certain conditions.

The PCAOB is working with other oversight bodies in several non-U.S. jurisdictions to establish similar cooperative arrangements, according to Rhonda Schnare, PCAOB director of international affairs.

FINANCIAL REPORTING

■ The AICPA's Financial Reporting Executive Committee (FinREC) commented on FASB's Proposed Accounting Standards Update, *Leases*. The exposure draft was developed jointly with the International Accounting Standards Board (IASB).

FinREC said it supports the boards' overall objective to develop a single approach to lease accounting and to require

assets and liabilities arising under leases to be recognized in lessees' statements of financial position. However, FinREC believes there are fundamental application issues not addressed by the ED, and revisions that need to be made to various aspects of the boards' proposal, including those related to the right-of-use approach to lessee accounting.

The FASB proposal would result in a single "right-of-use" approach applied consistently to lease accounting for lessees and lessors. Among other changes, the approach would result in the liability for payments under all lease contracts within the scope of the standard and the right to use the underlying asset being included on the lessee's balance sheet. The standard setters say the changes would improve the information available to investors and other financial statement users about the economics surrounding lease contracts.

Unlike FASB's discussion paper, *Leases: Preliminary Views*, published in March 2009, which focused primarily on lessee accounting, the ED, *Leases*, would result in changes on both sides of a lease transaction. A lessor would apply either a performance obligation approach or a derecognition approach. "The majority of FinREC members do not support the boards' hybrid (lease classification) approach to lessor accounting—instead they support the derecognition approach as the single lessor accounting model," FinREC said in its comment letter.

The proposal includes simplified accounting for short-term leases—leases having a maximum term of 12 months or less. The simplified accounting would allow lessees to ignore the effects of interest on the recorded assets and liabilities and allow the lessee to record the liability for lease payments at the undiscounted amount for lease payments. The simplified accounting would allow the lessor not to recognize assets or liabilities arising from a short-term lease, nor derecognize any portion of the underlying asset.

In its comment letter, FinREC said, "We do not support the boards' approach to accounting for lease renewal options and contingent rents. We believe that the lease

term should be defined as the lessee's (lessor's) best estimate of the lease term. We believe contingent rents and expected payments under residual value guarantees should be included in the measurement of assets and liabilities based on management's best estimate of payments to be made (received) under the lease."

■ FASB proposed to delay indefinitely the effective date of new disclosures about troubled debt restructurings in Accounting Standards Update (ASU) no. 2010-20 (tinyurl.com/27ok7ug) for public-entity creditors. The new standard was scheduled to become effective for interim and annual reporting periods ending on or after Dec. 15, 2010.

The board said the proposal is a response to constituents' concerns that the introduction of new disclosure requirements (paragraphs 310-10-50-31 through 50-34 of the FASB Accounting Standards Codification) about troubled debt restructurings in one reporting period followed by a change in what constitutes a troubled debt restructuring shortly thereafter would be burdensome for preparers and may not provide financial statement users with useful information.

The delay would apply to all public-entity creditors that modify financing receivables within the scope of the disclosure requirements about troubled debt restructurings in ASU no. 2010-20. For non-public entities, the disclosures would still be scheduled to go into effect for annual reporting periods ending on or after Dec. 15, 2011.

The amendments are included in Proposed ASU, *Receivables (Topic 310): Deferral of the Effective Date of Disclosures about Troubled Debt Restructurings in Update No. 2010-20* (tinyurl.com/35a75fe). FASB said constituents asked the board to defer the effective date of the disclosure requirements for public entities about troubled debt restructurings in ASU no. 2010-20, *Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*, to be concurrent with the effective date of the guidance for determining what

constitutes a troubled debt restructuring, as presented in the Proposed ASU, *Receivables (Topic 310): Clarifications to Accounting for Troubled Debt Restructurings by Creditors* (tinyurl.com/2d3hv25).

The board said the delay would give it time to complete its deliberations on what constitutes a troubled debt restructuring. The effective date of the new disclosures about troubled debt restructurings for public entities and the guidance for determining what constitutes a troubled debt restructuring would then be coordinated. The board said the guidance for determining what constitutes a troubled debt restructuring is likely to be effective for interim and annual periods ending after June 15, 2011.

The comment period closed Dec. 24. ■ FASB issued an Accounting Standards Update (ASU) that it said should end a “diversity in practice” in the disclosure of pro forma revenue and earnings for business combinations. The ASU says that, if comparative financial statements are presented, the pro forma revenue and earnings of the combined entity for the comparable prior reporting period should be reported as though the acquisition date for all business combinations that occurred during the current year had been as of the beginning of the comparable prior annual reporting period.

The amendments are contained in ASU 2010-29, *Business Combinations (Topic 805), Disclosure of Supplementary Pro Forma Information for Business Combinations—a consensus of the FASB Emerging Issues Task Force* (tinyurl.com/672zs7s).

FASB Accounting Standards Codification paragraph 805-10-50-2(h) requires a public entity to disclose pro forma information for business combinations that occurred in the current reporting period, according to ASU 2010-29. The disclosures include pro forma revenue and earnings of the combined entity for the current reporting period as though the acquisition date for all business combinations that occurred during the year had been as of the beginning of the annual reporting period.

In practice, the ASU says, some pre-

(Continued from page 15)

benefits. The rule also specifies that recipients who previously could obtain the same result by suspending their benefits retroactively now may make such suspensions only prospectively.

Primary beneficiaries may start receiving benefits as young as age 62, but at only 75% of benefits available to them at full retirement age (66, for applicants born between 1943 and 1954). The percentage increases to 100% as applicants approach full retirement age. They may also delay applying past full retirement age up to age 70 and receive still higher benefits. Although the Social Security Act does not explicitly permit it, a “longstanding policy” has allowed retirees to stop their benefits, repay them—without interest—and resume them at a higher amount.

“Recent media articles have promoted the use of our application withdrawal process as a means for retired beneficiaries to increase their benefits or acquire an ‘interest-free loan,’ ” the SSA said in describing the amended rules (Fed. Reg. 75:235, page 76257, Dec. 8, 2010). The SSA said its field offices reported that such withdrawals had increased in recent years. Other reasons recipients sometimes stop their benefits include continuing to work after they had planned to retire and thereby exceeding an annual earnings limit.

parers have presented the pro forma information in their comparative financial statements as if the business combination that occurred in the current reporting period had occurred as of the beginning of each of the current and prior annual reporting periods. Other preparers have disclosed the pro forma information as if the business combination occurred at the beginning of the prior annual reporting period only, and carried forward the related adjustments, if applicable, through the current reporting period.

FASB said the amendments improve the usefulness of the pro forma revenue and earnings disclosures by requiring a description of the nature and amount of material, nonrecurring pro forma adjustments that are directly attributable to business combinations.

The amendments are effective prospectively for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after Dec. 15, 2010. Early adoption is permitted.

GOVERNMENT

■ GASB issued an exposure draft that it said would improve financial reporting by

reducing uncertainty regarding the financial statement presentation of deferrals and their effects on a government’s net position. GASB said the proposal would provide guidance where none existed.

GASB said in a press release that the ED, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position*, proposes requirements for the reporting of deferred inflows of resources, deferred outflows of resources, and net position in a statement of financial position.

The proposed requirements would result in amendments to the requirements of Statement no. 34, *Basic Financial Statements—and Management’s Discussion and Analysis—for State and Local Governments*, and related pronouncements. GASB said that when Statement no. 34 was issued in 1999, it required the presentation of assets, liabilities and net assets in a statement of financial position. However, in 2007, GASB issued Concepts Statement no. 4, *Elements of Financial Statements*, which identifies and defines five elements that make up a statement of financial position. Besides assets and liabilities, Concepts Statement no. 4 introduced the elements of deferred outflows of resources and

deferred inflows of resources, and established the residual measure as net position, rather than net assets. For this reason, and because recent GASB pronouncements have either already addressed, or are expected to address, transactions requiring the use of deferred outflows of resources or deferred inflows of resources, guidance is needed to address their presentation in financial statements, GASB said.

The proposed Statement would be effective for financial statements for periods beginning after June 15, 2011, with earlier application encouraged. Accounting changes adopted to conform to the provisions of this Statement would be applied retroactively. The ED is available at tinyurl.com/32sup7s. The comment period closed Feb. 25.

INTERNATIONAL

■ In its response to a recent European Commission (EC) green paper, *Audit Policy: Lessons from the Crisis*, the AICPA said

that any resulting recommendations for improvements to the audit profession should be subject to robust cost/benefit analyses and impact assessments. The Institute also challenged any implication that the “audit profession somehow contributed to the financial crisis.”

The EC’s green paper is available at tinyurl.com/26abdtw. The AICPA’s response to the green paper is available at tinyurl.com/28gs4e.

The AICPA agreed that the “audit profession plays an important role in maintaining trust and confidence in the capital markets” and that “there may be lessons learned that could possibly improve the role and quality of the audit.” The AICPA’s letter, which was signed by Board Chairman Paul Stahlin and President and CEO Barry Melancon, also said that many of the issues addressed in the green paper need to be considered in the broader context of the responsibilities of regulators, audit committees and boards of directors and

the roles they play with respect to high-quality audits. The AICPA also noted that the EC should take into account the global marketplace in which audits are conducted and recognize that any measures implemented in the European Union will very likely impact audit practice and regulatory regimes outside the EU.

The green paper said that, in the aftermath of the global financial crisis, “limited attention has been given so far to how the audit function could be enhanced in order to contribute to increased financial stability.” The paper addresses issues in the following areas: (1) the role of the auditor; (2) governance of independence of audit firms; (3) supervision; (4) concentration and market structure; (5) creation of a European market; and (6) simplification for small and medium-size enterprises and practitioners.

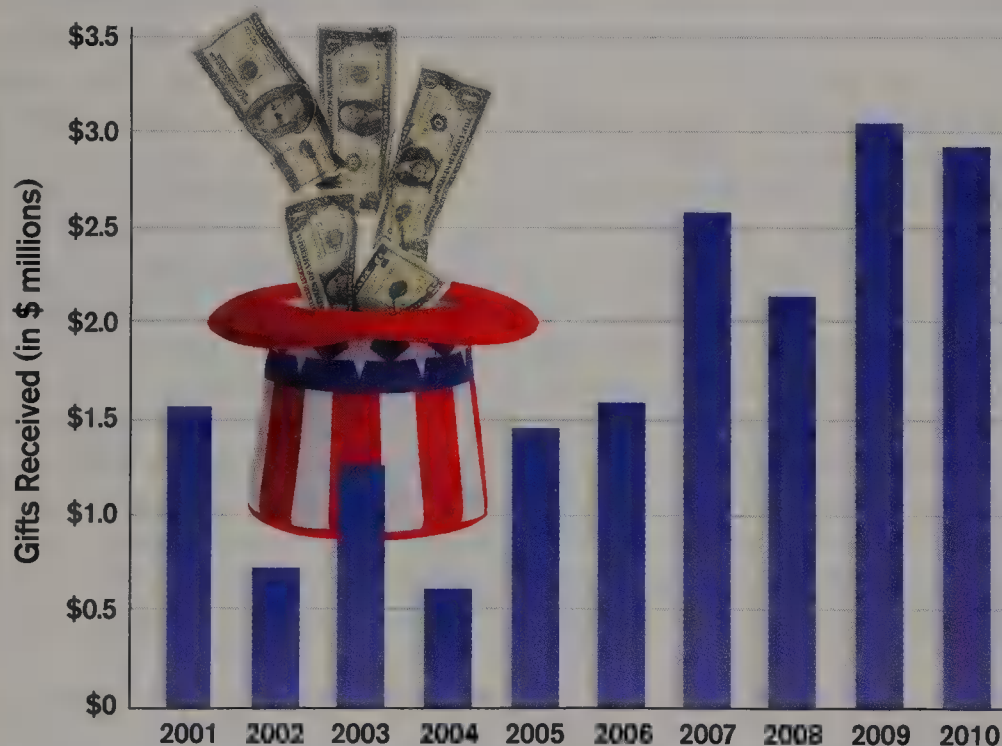
The AICPA said that any discussion of audit quality processes should consider users’ needs of the audit and their willingness to absorb the added costs for incremental increases in quality, stressing the need for a balance between the additional costs of audit enhancements and the resulting benefits to users of audits.

The AICPA said that certain measures the green paper recommended to enhance independence (such as prohibitions of nonaudit services by auditors, appointment of the auditor by third party, and mandatory firm rotation) are unnecessary and that the existing safeguards and prohibitions contained in the International Ethics Standards Board for Accountants (IESBA) *Code of Ethics for Professional Accountants* are sufficient to ensure auditor independence. The Institute argues that “some of these measures may actually undermine audit quality.”

The comment letter cited several studies that show that mandatory audit firm rotation “is not a desirable approach and can result in significant costs and inefficiencies for companies and their shareholders.” The AICPA believes that existing safeguards and restrictions, including rotation of the key audit partner for listed entities, are sufficient to safeguard auditor

Gifts to Uncle Sam

The U.S. Treasury’s Bureau of the Public Debt accepts gifts to help pay down the national debt. The \$2,840,466.75 received in fiscal 2010 was equal to the amount of new debt the government incurred, on average, every 55 seconds during the fiscal year ending Sept. 30, 2010.



Source: U.S. Treasury Department, tinyurl.com/6mm86u.

independence.

While the AICPA recognized that certain nonaudit services may result in threats to independence that cannot be mitigated, such as taking on management responsibilities, it argued that many nonaudit services do not impose a significant threat provided appropriate safeguards are implemented. The AICPA also listed the following factors in favor of having auditors perform nonaudit services:

1. The diversity of skills offered by firms enhances quality and efficiency of the audit and nonaudit services performed;
2. A prohibition of nonaudit services could result in clients' losing the breadth of knowledge and skills offered by multidisciplinary firms; and
3. The opportunity to offer nonaudit services within a firm enhances the recruitment and retention of high-quality professionals.

The EC noted a concern for the systemic risk inherent in a market dominated by the Big Four audit firms, whose market share of audits for listed companies "exceeds 90% in a vast majority of EU member states." The green paper warns that "[t]he market appears to be too concentrated in certain segments and den[ies] clients sufficient choice when deciding on their auditors."

While the AICPA said it does not support the mandatory formation of audit firm consortiums, the Institute said the EC "should continue its focus on measures that will assist small and medium-size practitioners (SMPs) with entering the audit market but refrain from taking any action where it intervenes directly in the market since such actions have unintended consequences."

With regard to promoting SMP growth in the market, the AICPA recommended that the EC consider:

1. Public disclosure of third-party agreements that limit auditor choice;
2. Including representatives of small auditing firms in committees, public forums, fellowships and other engagements; and
3. Addressing other barriers to audit firm growth such as liability risks and the

ability to obtain adequate liability insurance. The AICPA said that, although SMPs in the U.S. currently have access to commercially available liability insurance, the substantial expansion of these firms could result in increased insurance costs and could ultimately result in insurers' being unwilling to provide coverage to these firms.

The Institute also expressed support for mutual recognition agreements (MRAs) among accounting bodies and regulators to provide cross-border audit rights, which it said are critical to the facilitation of cross-border mobility of auditors. The AICPA also noted that it is imperative that regulators across the globe work together toward a common oversight and regulatory framework with reliance placed on the home country regulator.

■ The IASB issued amendments to IAS 12, *Income Taxes*, and what it called "narrow amendments" to IFRS 1, *First-time Adoption of International Financial Reporting Standards*.

The amendments to IAS 12 were proposed in an exposure draft in September.

IAS 12 requires an entity to measure the deferred tax relating to an asset depending on whether the entity expects to recover the carrying amount of the asset through use or sale. The IASB said in a press release that it can be difficult and subjective to assess whether recovery will be through use or through sale when the asset is measured using the fair value model in IAS 40, *Investment Property*. The IASB said the amendment provides a practical solution to the problem by introducing a presumption that recovery of the carrying amount will normally be through sale.

As a result of the amendments, SIC-21, *Income Taxes—Recovery of Revalued Non-Depreciable Assets*, will no longer apply to investment properties carried at fair value. The amendments also incorporate into IAS 12 the remaining guidance previously contained in SIC-21, which is withdrawn.

The amendments to IFRS 1 were published as separate EDs in August and September. They include replacing references

to a fixed date of "1 January 2004" with "the date of transition to IFRSs," eliminating the need for companies adopting IFRS for the first time to restate derecognition transactions that occurred before the IFRS transition date.

The amendments to IFRS 1, set out in *Severe Hyperinflation and Removal of Fixed Dates for First-time Adopters*, are effective from July 1, 2011. Earlier application is permitted.

Visit ifrs.org for more details.

FYI

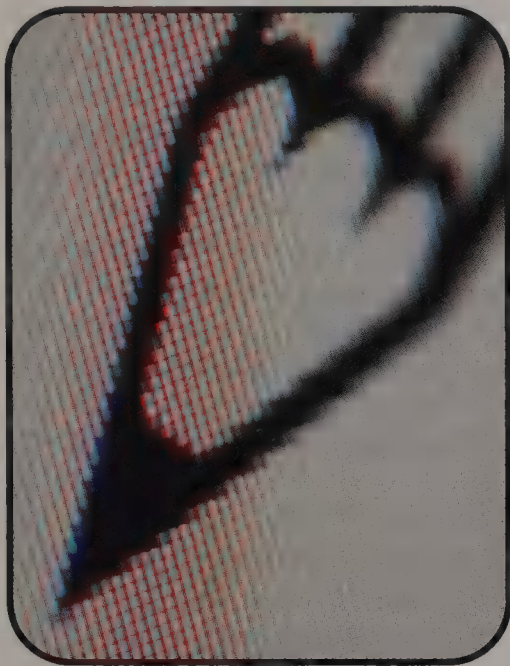
■ Leslie F. Seidman was named FASB chairman on Dec. 23. She had been acting chairman since the retirement of Robert Herz on Sept. 30 and has been a FASB member since 2003.

■ The SEC appointed James Doty PCAOB chairman and named Jay Hanson and Lewis Ferguson members of the board. Doty is a Washington-based securities lawyer and a former SEC general counsel. Ferguson, also a Washington securities lawyer, served for more than three years as the PCAOB's first general counsel. Hanson is a partner and the national director of accounting at McGladrey & Pullen LLP in Bloomington, Minn., with responsibility for leading the firm's accounting standards group. He is chair of the AICPA's Financial Reporting Executive Committee and a member of FASB's Emerging Issues Task Force. ♦

CORRECTIONS & CLARIFICATIONS

■ In the January 2011 issue, the "Filing Season Quick Guide—Tax Year 2010" misstated the first-time homebuyer credit for some married taxpayers. It should have said the credit is \$4,000 for married taxpayers filing *separately*.

■ The February 2011 article "Tax Practice Corner: Multistate Tax Considerations for S Corporations" listed Louisiana among states that "tax S corporations in the same manner as C corporations." However, Louisiana allows an S corporation to exclude from taxable income the percentage of its net income on which its shareholders have paid Louisiana taxes.



Make Your Mark With Your Social Media Status

Blogging and social networking truly remind your clients and colleagues of why, when and how to recommend or refer you. Here are some tips on how to put social media status updates and other low-maintenance missives to work for you:

✓ **Don't sell ... do share.** Selling accounting services on your blog or in status updates is the No. 1 faux pas. Rather, educate and share related links. By highlighting your breadth of expertise, readers will ask you questions that will lead to more billable hours. Likewise, comment on others' blog articles, status updates and group discussions. Invite them to e-mail or phone you, to avoid privacy or ethics violations.

✓ **Focus on what you know and what you're doing.** Blog posts and status updates are reminders of what you're doing or what your clients should be doing (for example, preparing for tax deadlines). Mentions of upcoming seminars and media are subtle commercial plugs. You can also explain accounting jargon, credentials and other specialized acronyms. Likewise, discuss upcoming or recently passed tax laws and other regulations.

✓ **Be a resource for new clients.** Your blog is a handy resource for referrals to learn about you, and how to prepare before meeting with you. They don't know what they don't know: Teach them what to ask a CPA before choosing one. Dispel misconceptions

about your practice. Share the unique accounting nuances of your target market (such as specialized accounting for contractors or nonprofits). Tell readers what documents to bring and to store. Keep track of frequently asked questions (FAQs) from clients; answer them on your blog so others can benefit. Mention these resources in status updates.

✓ **Appreciate others through your blog and updates.** Your blog provides a public platform for you to thank your staff and partners for their work. Clients will learn about your firm this way. You can also thank clients and colleagues for their referrals. Moreover, you can congratulate others for their charitable leadership. Just be sure to get the appropriate permissions before posting names.

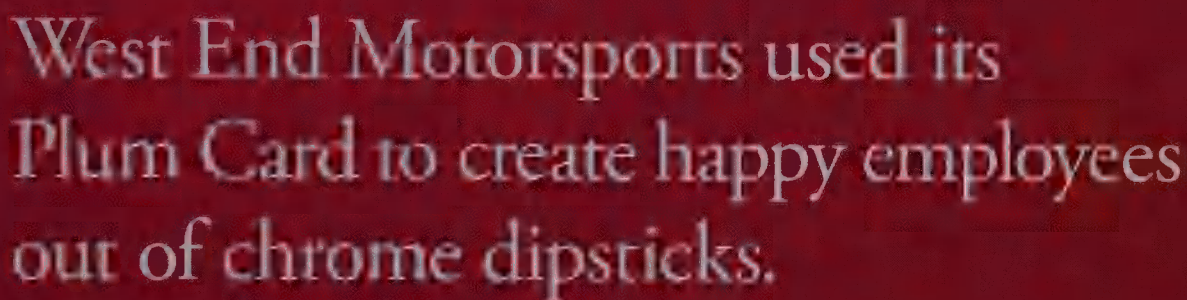
✓ **Share your continuing education and personal development.** What are you reading ... right now? What CPE courses are you attending ... right now? Share your experience and thoughts through your blog. This helps clients, prospective clients and other referral sources learn how you continually sharpen your expertise. You can also share nonaccounting reading and personal development information. Again, this educates your readers and

showcases you as a well-rounded CPA.

✓ **K.I.S.S. with multimedia.** Keep It Short and Simple: Blog posts can be PowerPoint slides (embedded using SlideShare), YouTube videos, or diagrams, graphs, cartoons and other images. Likewise, your blog posts and status updates can link to longer articles.

✓ **Integrate your blog and social media updates into your practice.** You don't have to blog/update every day, but you should do so more than once a month. Many CPAs post a new blog article twice a month and send out a digest as an e-newsletter (with a "read more" link back to their website). Link back via LinkedIn, Twitter and Facebook. It's handy to mention your LinkedIn or other social networking profiles in your e-mail signature. (For more on LinkedIn in this issue, see "LinkedIn Tips for CPAs," page 44 and "Are You Linked In?" page 48.) Remind clients (and other referral sources) that your website has a resource section, that is, your blog.

—By **Vikram Rajan** (vik@phoneblogger.net), the founder of *phoneBlogger.net* and author of the *PracticeMarketingBLOG.com*.
Editor's note: A version of this story originally appeared in the AICPA CPA Insider newsletter.

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Scenario Planning: Navigating Through Today's Uncertain World

by David A.J. Axson

Imagine you are sitting at your desk in September 2007. The Dow is close to 13,900; U.S. unemployment is 4.5%; and oil is \$45 a barrel. You are in the middle of developing your organization's plans and budgets for 2008. How likely is it that the assumptions in your 2008 plan accurately forecast that in September 2008 the Dow will be below 9,000; U.S. unemployment will have risen to 6.5%, on its way to more than 10%; and oil prices will have risen to more than \$140 a barrel before falling below \$40 a few months later?

An aberration? Unlikely, not with a European sovereign debt crisis, a massive oil spill in the Gulf of Mexico and major health care reform in the United States. Uncertainty, volatility and risk are here to stay. The world has been transformed from a series of loosely connected, reasonably predictable economies to a complex web of relationships where the global impact of local events is felt almost instantaneously.

In this climate the past is not a good predictor of the future. In response to such uncertainty, scenario planning has been used by organizations as diverse as the Australian

government, AutoNation, British Airways, Corning, Disney, General Electric, the U.S. Federal Highway Administration, JDS Uniphase, KinderCare (a large U.S. chain of day care centers), Mercedes, Royal Dutch Shell, UPS and the World Bank. Today, scenario planning is being widely used by many small and midsize organizations operating in uncertain or volatile markets.

WHAT IS SCENARIO PLANNING?

Scenario planning is a way of understanding the forces at work today, such as de-

mographics, globalization, technological change and environmental sustainability that will shape the future. While the origins of scenario planning were in the world of strategic planning, many organizations now apply scenario planning techniques to the operational planning, budgeting and forecasting processes as a means of evaluating their effectiveness under different sets of assumptions about the future.

Two forces are fueling the increased popularity and use of scenario planning. The first is the rapid and broad global impact of unpredictable events such as 9/11,



or the global credit crisis. The second is the accelerated pace at which new trends become material. For example, the rapid growth of China and India, the rise of social media, and smart phone adoption have occurred in a decade or less.

BUILDING SCENARIO PLANS

Scenario planning is largely focused on answering three questions:

1. What could happen?

2. What would be the impact on our strategies, plans and budgets?

3. How should we respond?

Although there are numerous methodologies for building scenario plans, they all follow the same basic approach (see Exhibit 1).

Before embarking on a scenario planning exercise, it is essential to be clear about the issue you want to address, and then to define the appropriate scope and time horizon for the scenarios to be constructed.

There are four broad types of scenarios:

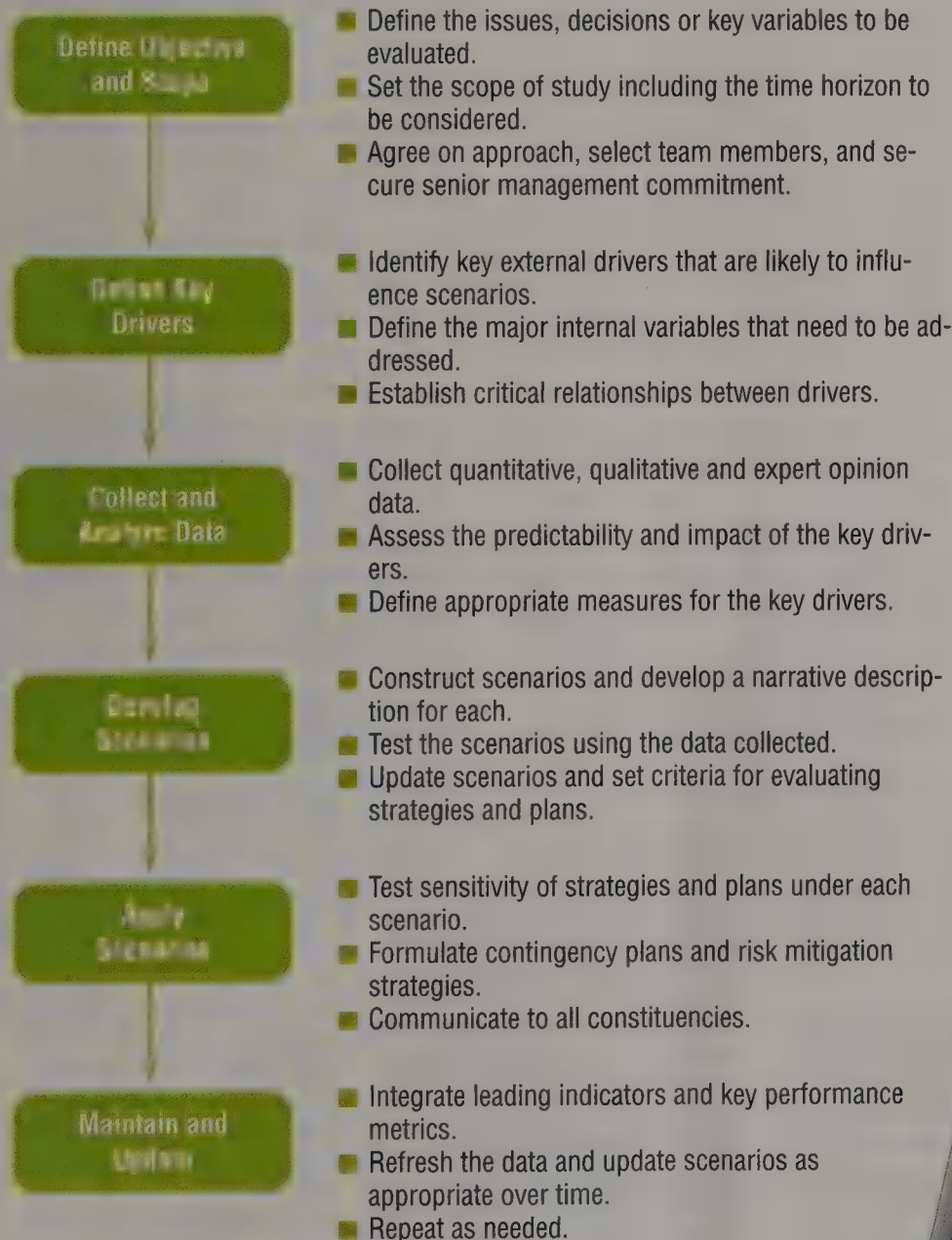
1. **Social.** For example, what are the implications of increasing obesity?
2. **Economic.** For example, how will the rapid economic growth of China and India change global markets?
3. **Political.** For example, how will changes in U.S. health care policy affect the economics of small businesses?
4. **Technological.** For example, how will the increasing use of smart phones impact desktop and laptop computer use?

Answering the following questions will help determine whether a scenario planning project makes sense and how to define the objectives and scope:

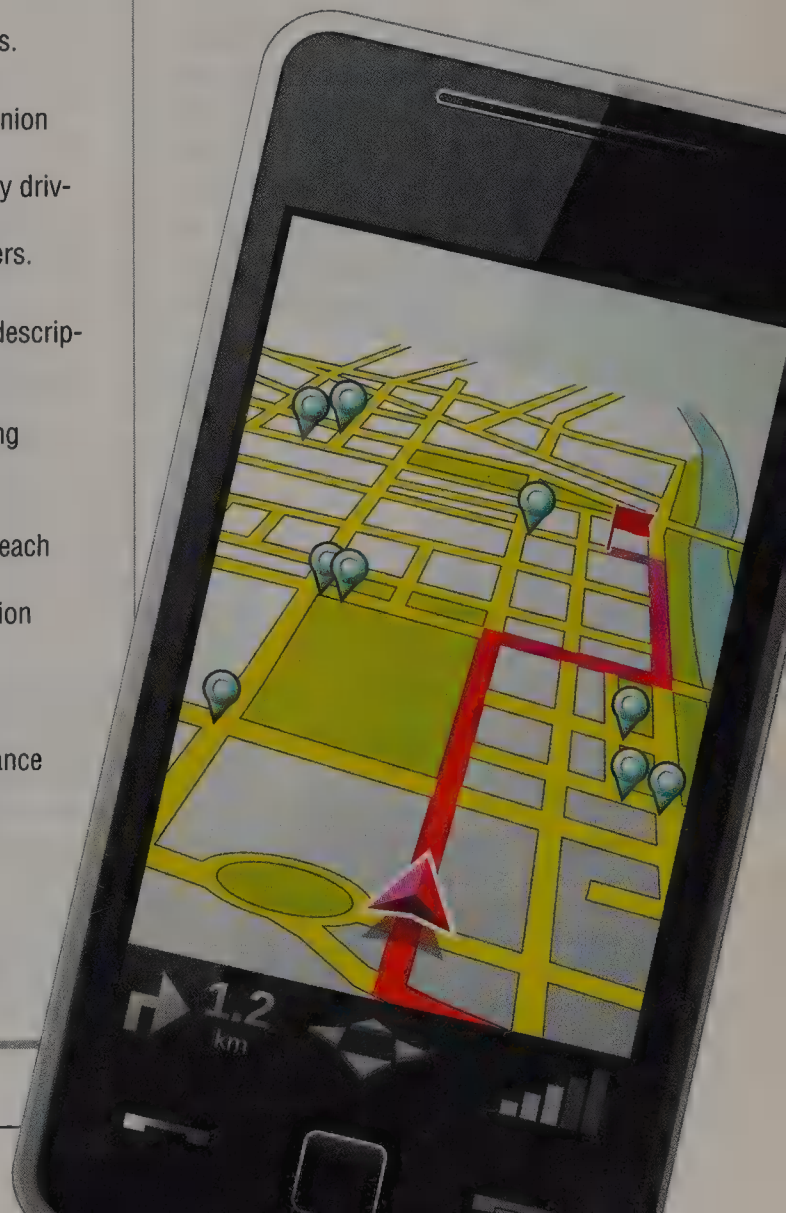
- What issues or decisions are we trying to evaluate?
- Is there a high degree of uncertainty about the future? If yes, can scenario planning be an effective tool?

Exhibit 1

Scenario Planning Work Approach



Source: Management Accounting Guideline, *Scenario Planning: Plotting a Course Through an Uncertain World*, AICPA, CMA Canada and CIMA, 2010.



- What is the time horizon for making decisions and then executing them?

After the organization has agreed on the issue(s) to be studied and defined the scope and time horizon for the project, they should be documented, confirmed with senior management, and clearly communicated to everyone who will be involved in the project.

At the end of this step, the project team should have developed a project charter that clearly states the objectives, scope, issues to be addressed, deliverables, and have secured approval from senior management.

can provide valuable insights as to how the future may unfold, thereby equipping organizations to react with speed, agility and confidence.

Scenario planning is often used as an input to an organization's overall risk management process and can aid in areas of interest to CPAs such as risk appetite evaluation, capital planning, credit quality, cash flow forecasting and hedging strategies.

An understanding of scenario planning equips CPAs with tools that can help advance their careers into more senior finance or general management roles through a richer understanding of how to effectively

and leading indicators to track potential triggers of key drivers of alternate scenarios; and

- Monitoring and reporting on internal performance and external indicators likely to impact the current strategy.

SCENARIO PLANNING IN ACTION

Let's see how scenario planning can work in practice by following the progress of ElectricIQ, a software company that develops smart systems for managing electricity use. This case study is based upon a real organization. Some details have been changed to maintain client confidentiality.

ElectricIQ was founded in 2005, and by 2009 sales had reached \$25 million a year, primarily from the installation of electricity management systems in new office buildings in Western Europe. Management believed that ElectricIQ had reached a tipping point.

With environmental sustainability becoming a hot public policy issue, the company believed it was time to enter the emerging smart grid market for digital environmental management systems. Management wanted to gain insights as to the relative attractiveness/risk of the market.

The company decided to embark upon a scenario planning project to help understand the alternatives as an input to R&D, marketing and product development plans. A project team led by the CFO and

Many organizations are looking to their CPA partners for support in conducting rigorous and insightful analysis.

ROLE OF THE CPA IN SCENARIO PLANNING

Finance and accounting professionals are being asked to help managers better understand the threats and opportunities in today's world. As many organizations integrate aspects of scenario planning into financial planning, budgeting and forecasting processes, they are looking to their CPA partners for support in conducting rigorous and insightful analysis.

Applied judiciously, scenario planning

manage in a volatile and uncertain world.

CPAs can effectively support a scenario planning process in their organizations by:

- Analyzing the financial implications of alternative strategies under different future scenarios;
- Testing the sensitivity of key assumptions, financial measures and variables under different scenarios;
- Developing alternative financial plans and forecasts under different scenarios;
- Defining key performance measures

EXECUTIVE SUMMARY

■ **The past is not a good predictor of the future.** To respond to uncertainty, finance and accounting professionals can use scenario planning to help managers better understand the threats and opportunities in today's world.

■ **Scenario planning is not just a strategic planning tool.** Many organizations now apply it to operational planning, budgeting and forecasting processes to evaluate their effectiveness under different assumptions.

■ **There are four broad types of scenarios:** (1) Social, (2) Economic, (3) Political and (4) Technological.

■ **Scenario planning is largely focused on answering three questions:** (1) What could happen? (2) What would be the impact on our strategies, plans and budgets? And (3) How should we respond?

■ **Scenario planning equips CPAs with tools for career advancement.** It enables CPAs to effectively support the strategic

planning process; provides a frame of reference for developing alternative financial plans and forecasts; tests the sensitivity of key assumptions, financial measures and variables under different scenarios; and helps define key performance measures.

■ **It is essential to be clear about the issue you want to address before embarking** on a scenario planning exercise, and then to define the appropriate scope and time horizon for the scenarios to be constructed.

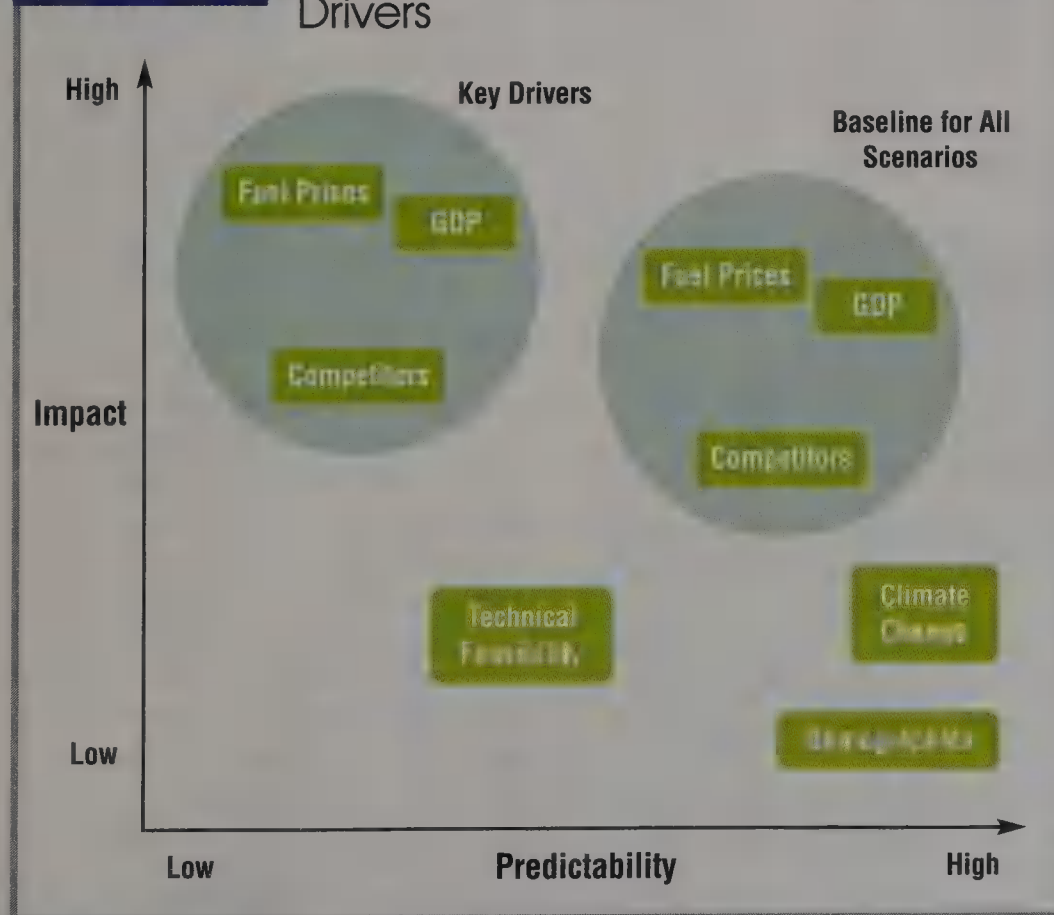
David A.J. Axson (david@davidaxson.com) is the author of the Management Accounting Guideline Scenario Planning: Plotting a Course Through an Uncertain World, published July 2010 by the AICPA, CMA Canada and CIMA, from which this article has been adapted.

To comment on this article or to suggest an idea for another article, contact Matthew G. Lamoreaux, senior editor, at mlamoreaux@aicpa.org or 919-402-4435.

Exhibit 2 ElectricIQ Driver Map



Exhibit 3 Evaluation and Identification of Key Drivers



including the vice president of marketing, the head of research and a financial analyst was formed, and after initial discussions with the management team, the project's objectives were defined as "Developing a better understanding of the markets for smart grid, the risk profiles of each market and the ease of market access."

The first step for the ElectricIQ team was to identify the likely drivers of the future environment. This is the most important step in scenario planning since the ability to define the correct drivers and then understand the impact of changes in drivers is at the heart of effective scenario planning. Through discussions with the management team, customers, investors and external thought leaders from the Organisation for Economic Co-operation and Development (OECD), General Electric, IBM and Shell, the team developed a simple driver model around the issue of the *Demand for Renewable Energy Sources*. Two level 1 drivers, *Social Opinion* and *Political Action*, were identified, and each level 1 driver was then mapped to three level 2 drivers. For social opinion, these were the credibility of climate change data, the technical viability of potential renewable energy sources and the price of such options. For political action, they were the availability of government subsidies, the regulatory framework and the role of tax policy in energy use (see Exhibit 2). The team then used this framework to identify the types of data it would collect.

This included data about economic growth; forecasts of construction activity; likely government actions to encourage adoption of environmental control systems; and the likely players in the market for environmental control systems. Not all the data was quantitative; some of the most interesting inputs were the opinions of experts who specialize in conceptualizing alternative futures. The key is to collect a broad range of data with a view to developing credible scenarios of how the future may look.

The team then prioritized the drivers by mapping them against two axes. The first axis was an assessment of each driver's impact on the issue being analyzed, and the

second looked at the predictability of future trends for each driver (see Exhibit 3). Drivers that were both material and predictable (top-right circle) formed the basis for all scenarios that were developed. Those that were material but difficult to predict

(top-left circle) defined the differences between the scenarios.

The team isolated those drivers that were most likely to shape future demand. It then developed four scenarios across two dimensions (see Exhibit 4). The dimensions were

public opinion, which describes the level of consumer demand for environmentally friendly solutions, and public policy, which describes the extent to which government policy mandates “green” standards.

The team then developed narrative descriptions for each scenario:

Necessity. “Do It or Die”: Public opinion swings rapidly to green solutions and dramatically changes customer buying patterns. Products not seen as being green are shunned in the marketplace. Governments mandate adoption of environmentally friendly technologies.

Market driven. “Competitive Advantage”: Public opinion moves to green, and consumers will pay extra for the best products. Adoption is balanced between market innovation and tax-based incentives. Being green is a source of competitive advantage.

Mandate. “Cost of Doing Business”: Governments mandate adoption without incentives. Adoption is a “cost of doing business.” Consumers will not pay more for green solutions unless forced to do so.

The “S” curve. “Steady as She Goes”: Demand follows a traditional cycle of early adopters leading the way at high prices; as the market scales and prices drop, mass market adoption takes off before flattening out as maturity is reached.

ElectricIQ used these scenarios to frame strategies and make decisions affecting key elements of the business (see Exhibit 5).

Using the scenarios as a baseline, ElectricIQ’s finance team recast the company’s five-year plan and annual budget under each scenario to assess the financial implications and identify key performance metrics that could provide the organization with an early warning as to which scenario is actually playing out. The CFO also added metrics that tracked the key drivers to the company’s balanced scorecard, ensuring their constant visibility to the management team.

But the work was not done—scenario planning is not a one-off exercise. For example, what if just six months after the initial scenarios were completed, oil reached \$200 a barrel and the G-20 imposed strict mandates on CO₂ emissions to be met within five years? ElectricIQ would have

Exhibit 4 ElectricIQ Scenario Development

Mandate	Cost of Doing Business	Do It or Die
Public Policy	Steady as She Goes	Competitive Advantage
Subsidized		
	Early Adopter	Public Opinion
		Mass Market Adoption

Exhibit 5 Scenario Implications

	Do It or Die	Competitive Advantage	Cost of Doing Business	Steady as She Goes
Approach to Innovation	The minimum is not enough; must be the best to win	Innovative leadership has real value	Must meet the standards; little advantage in being a leader	Focus on select areas where there is strong demand
Marketing Strategies	Either be the safe option (compliant) or the best	Must be a leader	Partner with builders to secure share	Be No. 1 in select niches
Market Goals	Own the high end	Acquire share	Be the preferred supplier	Build share in niches
Financial Goals	High margins	Focus on size and scale	Low-cost producer	Modest growth over time

had to revisit its plans and may have decided to focus on only two of the original four scenarios: "Do It or Die" and the "Cost of Doing Business." After more detailed modeling of these two scenarios, it could decide to focus on delivering solutions that far exceed the mandated minimums while keeping prices reasonable.

The scenario plans allow them to make fast, confident decisions by providing a sound basis for evaluating the impact of changing market conditions. As the CFO commented, "We constantly review our actual and forecasted results against the scenarios so we can act quickly when we see any changes in the marketplace that will impact our performance."

As organizations struggle to deal with an increasingly uncertain world, they are looking to their finance teams to assist in helping them understand the choices, opportunities and implications that uncertainty presents. ♦

AICPA RESOURCES

JofA articles

- "Tom Ridge: Dive Deep to Anticipate Enterprise Risks," July 2009, page 46
- "Creating Growth: Using Opportunity Risk Management Effectively," June 2008, page 72

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- *AICPA's Annual Update for Controllers* (#731976)

Publications

- *Accountant's Business Manual* (#029418, with CD-ROM toolkit; and ABM-XX, online version)

- *CPA Client Bulletin* (#CB_FI12, CB_FN12 and CBEXX12)
- *CPA Client—A Review of the Small Business Jobs Act of 2010* (#030015PDF)
- *Risk Assessment for Mid Sized Companies: Tools for Developing a Tailored Approach to Risk Management* (#091101)
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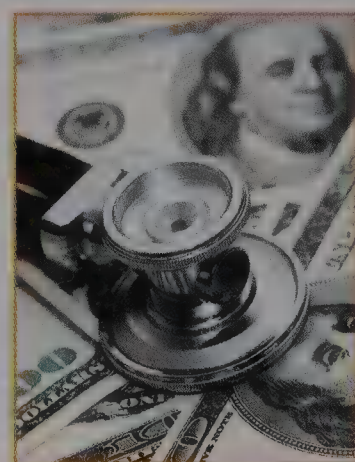
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Objectives

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- Identify important planning opportunities associated with the Act for businesses and individuals

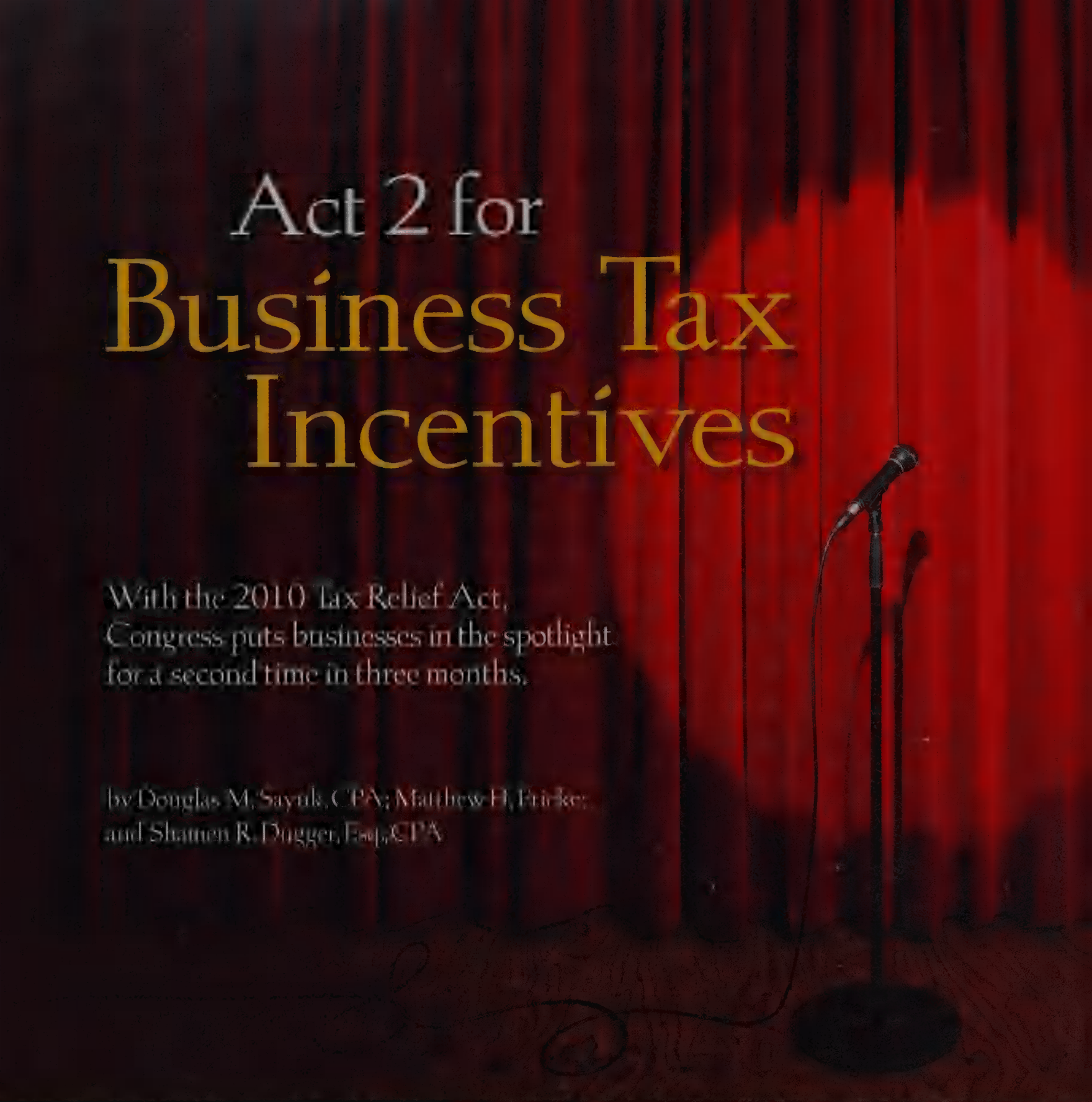


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Act 2 for Business Tax Incentives

With the 2010 Tax Relief Act,
Congress puts businesses in the spotlight
for a second time in three months.

by Douglas M. Sayuk, CPA; Matthew H. Fricke;
and Shamen R. Dugger, Esq., CPA

Enacted in the waning days of the 111th Congress, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (2010 Tax Relief Act, PL 111-312) was a creature of political compromise.

But the act nonetheless built upon already attractive incentives that had been passed only a few months before in the Small

Business Jobs Act of 2010 (PL 111-240). The jobs act, as explained in the *JofA* article “2010 Small Business Jobs Act: Good

for Big Business” (Dec. 2010, page 30), authorized a host of business incentives that, although designated for “small businesses,” statistically could apply to 99.9% of all U.S. businesses. The 2010 Tax Relief Act steps in where the Small Business Jobs Act ends, enhancing and extending business incentives, including IRC § 179 expensing, bonus depreciation and tax credits.

and accounting perspective, along with their key financial statement and tax return considerations.

STRATEGICALLY APPLYING THE ACTS' PROVISIONS TOGETHER

The Small Business Jobs Act and the 2010 Tax Relief Act are each significant to businesses on their own merits, as shown in the chart summarizing their important business incentive provisions (see Exhibit 1).

When the provisions of the Small Business Jobs Act and the 2010 Tax Relief Act are strategically merged, the benefits to businesses may be lucrative.

Research credit and five-year carry-back. Perhaps the greatest tax savings op-

portunity from the interplay of the two acts is that of the research credit and the general business credit five-year carry-back. The Small Business Jobs Act in IRC § 39(a)(4) authorized eligible small businesses to carry back general business credits generated during 2010 to the prior five tax years (2005 to 2009). Eligible small businesses are corporations whose stock isn't publicly traded, partnerships or sole proprietorships that have average annual gross receipts for the three-tax-year period preceding the tax year of no more than \$50 million (section 38(c)(5)(C)).

The problem was that the act did not extend one of the most popular and most

Exhibit 1 Comparing the Acts

Business Incentive	Small Business Jobs Act	Tax Relief Act
Increased IRC § 179 expensing limit/phaseout threshold	\$500,000/\$2 million for 2010 and 2011; qualifying property widened to include certain real property	Through 2012, \$125,000/\$500,000
Bonus depreciation	50% through 2010	100% from Sept. 8, 2010, through 2011; 50% through 2012
15-year write-off of qualified leasehold improvements	Not included	Extended through 2010 and 2011
General business credit carryback for eligible small businesses	General business credits generated in 2010 may be carried back five years	Not included
Research credit	Not included	Extended through 2010 and 2011
Allowance of general business credits against AMT for eligible small businesses	During 2010, and prior five years via carryback	Not included
Refundable AMT credit	Not included	AMT credits may be accelerated in lieu of bonus depreciation

In this article, we compare the two acts' primary incentive provisions, then analyze the enhanced benefit produced by combining them. Finally, we provide guidance on how three typical company types (a loss company with a valuation allowance; profitable company with an NOL carryforward and valuation allowance; and a profitable company without a valuation allowance) will be affected by the acts from a cash flow

used federal general business credits, the IRC § 41 credit for increasing research activities that had expired Dec. 31, 2009. Without an extension to 2010 of the research credit, the credit carryback opportunity was of little or no value to many businesses. It was only when the 2010 Tax Relief Act was passed, extending the federal re-

erating federal research credits to offset their 2010 AMT, as well as AMT in the prior five years via the credit carryback opportunity.

Leasehold improvement and bonus depreciation. The Small Business Jobs Act extended 50% bonus depreciation for all businesses through Dec. 31, 2010. What the act

tail improvement property, respectively, as 15-year property. However, under sections 168(e)(7)(B) and 168(e)(8)(D), these types of property are not treated as qualified property for purposes of the bonus depreciation rules in section 168(k) and thus aren't eligible for bonus depreciation.

Bonus depreciation enhancement and extension. Although the two acts' provisions do not differ in kind, they work together to lengthen the period and extent to which bonus depreciation is available. The Small Business Jobs Act extended bonus depreciation through 2010, but at 50%. The 2010 Tax Relief Act bolsters this depreciation acceleration to 100% for qualified property purchased and placed in service between Sept. 8, 2010, and Dec. 31, 2011. Although this depreciation acceleration is merely a timing difference rather than a reduction in federal taxes, when applied to fixed assets of longer class lives (such as qualifying leasehold improvements at 15 years) the time value of money becomes significant. While interest rates are currently low, the accelerated depreciation may provide enhanced net operating loss carryback opportunities or guarantee that the deduction may be used to reduce taxes if 2010 or 2011 is profitable.

Section 179 expensing enhancement and extension. The Small Business Jobs

When depreciation acceleration is applied to fixed assets of longer class lives, the time value of money becomes significant.

search credit retroactively through 2010, that the credit carryback became meaningful to many eligible small businesses.

Research credit and AMT offset. In addition to the general business credit carryback, the Small Business Jobs Act authorized general business credits for eligible small businesses to offset alternative minimum tax (AMT) during 2010 and for the five-year carryback period. Once again, the problem faced by many businesses in using this tax savings opportunity was that the ever-popular research credit had expired. And, once again, the 2010 Tax Relief Act extension of the credit retroactively through 2010 reopened the potential for businesses gen-

erating federal research credits to offset their 2010 AMT, as well as AMT in the prior five years via the credit carryback opportunity. **Leasehold improvement and bonus depreciation.** The Small Business Jobs Act extended 50% bonus depreciation for all businesses through Dec. 31, 2010. What the act did not do was broaden the definition of what constitutes qualified leasehold improvements for purposes of bonus depreciation. The provision is significant to many businesses, as leasehold improvements typically are depreciated over 39 years, resulting in lower annual depreciation deductions. The 2010 Tax Relief Act fills this gap by extending through 2011 the section 168(e)(3)(E)(iv) rule treating qualified leasehold improvement property as 15-year property. Thus, such property is once again eligible for bonus depreciation.

The 2010 Tax Relief Act also extends through 2011 the section 168(e)(3)(E)(v) rule and the section 168(e)(3)(E)(ix) rule treating qualified restaurant property and qualified re-

EXECUTIVE SUMMARY

■ **The Small Business Jobs Act and 2010 Tax Relief Act** each enhanced and/or extended significant tax benefits for businesses, especially those that can combine certain provisions. These include an extension of the research credit (for 2010 and 2011), longer carryback of the general business credit arising in 2010 for eligible small businesses, and several measures for enhanced expensing and depreciation of business property.

■ **However, how these provisions are applied and their amount of benefit depend on**

the tax status of the business. For example, a loss company with a valuation allowance may benefit little from bonus depreciation and higher IRC § 179 expensing limits. A profitable company with NOL carryforwards and a valuation allowance can benefit in lower regular income tax and alternative minimum tax, and a profitable company without a valuation allowance will realize the greatest cash flow benefit from accelerating depreciation under the acts' provisions and carrying back general business credits, including the

research credit.

■ **A procedure is available to claim a refund arising from carrybacks more quickly** than by filing amended returns—*Application for Tentative Refund* (Form 1045) and *Corporation Application for Tentative Refund* (Form 1139).

■ **Companies that claim the research credit should maintain adequate documentation** to support the claim. For tax years beginning in 2010, companies required to file Schedule UTP reporting uncertain tax positions (generally, C corporations with

more than \$100 million in assets) may be required to include in that reporting any such uncertainty associated with claiming a research credit.

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Act expanded the section 179 expensing limit and phaseout threshold to \$500,000 and \$2 million, respectively, along with expanding the definition of qualified real property, but only through Dec. 31, 2011. The 2010 Tax Relief Act continues through Dec. 31, 2012, higher limits than if they had reverted in 2012 to prior-law rates (maximum expensing amount of \$25,000 and phaseout threshold of \$200,000).

NAVIGATING THE ACTS IN COMBINATION

Theoretically, it makes sense to apply the Small Business Jobs Act and 2010 Tax Relief Act in combination. But, practically speaking, how these acts' provisions are applied and the ensuing cash flow/accounting benefits depend greatly on the tax status of the business, as shown in Exhibit 2.

Loss company with valuation allowance.

Typically, loss companies with a valuation allowance will not benefit from the acts' provisions either on a cash flow or accounting basis. To the extent these companies are not currently incurring federal regular income tax or AMT and have not done so in the past, there is no potential to currently monetize any of the acts' benefits discussed in this article. From an accounting perspective, the depreciation-related benefits result in merely a swap of deferred tax asset (DTA) components from fixed-asset-related DTA to NOL-related DTA, and the credit opportunities are generally limited to a 2010 increase in DTA arising from a federal general business credit carryforward. No financial statement effects result from this redistribution and/or increase of DTA, due to the offsetting valuation allowance.

Profitable company with NOL carryforwards and valuation allowance. A prof-

itable company with NOL carryforwards and a valuation allowance will record a tax benefit from the acts' provisions. This type of company will use its NOL carryforwards to eliminate regular federal income tax and AMT, the latter down to the minimum 2% threshold (20% AMT multiplied by 10% AMT NOL utilization limitation). Therefore, to the extent front-loading depreciation deductions decreases the company's limited AMT NOL carryforward, the company will receive a current benefit from the reduction in AMT. No corresponding deferred tax impact will arise, due to the full valuation allowance.

The acts' credit opportunities also may be of current benefit to this company type, because now research (and other general business) credits may offset AMT, which is likely the type of tax this company is paying, due to its NOL utilization. This company type also is more likely to have

Exhibit 2

The Acts' Benefits for Three Company Types

Company type	Bonus depreciation / § 179 effects		Refundable AMT in lieu of bonus depreciation		Five-year research credit carryback for eligible small businesses	
	Cash flow benefit	Accounting benefit	Cash flow benefit	Accounting benefit	Cash flow benefit	Accounting benefit
Loss with valuation allowance	None	N/A; swap of deferred tax assets	Yes, if prior-year AMT claimed as no benefit from bonus depreciation	Current benefit for reduced AMT; no deferred impact	Only if prior-year taxes paid	Current benefit for reduced prior years' AMT; no deferred impact
Profitable with NOL carryforward and valuation allowance	2% AMT	Current benefit for reduced AMT; no deferred impact	Possible; may be more beneficial depending on amount of AMT carryforward	Current benefit for reduced AMT; no deferred impact	Offset of current-year AMT; carryback to offset prior years' AMT	Current benefit for reduced current and prior years' AMT; no deferred impact
Profitable without valuation allowance	35% regular tax	None; decrease in current expense offset by increase in deferred expense	Probably not; immediate 35% benefit likely more beneficial	None; decrease in current expense offset by increase in deferred expense	Offset of current-year AMT; carryback to offset prior years' AMT	None; decrease in current expense offset by increase in deferred expense

pre-2006 AMT credits that it can monetize, due to its typical pattern of paying federal AMT. Likewise, the company will record a current benefit without the corresponding deferred tax expense from credit utilization.

Profitable company without valuation allowance. Profitable companies without a valuation allowance must take into consideration deferred taxes as well as current taxes; thus, the deferred tax impacts from securing the acts' opportunities result in no net profit-and-loss impact. Under each opportunity addressed in Exhibit 2, the decrease in current tax expense is offset by a corresponding increase in deferred tax expense. From a cash flow perspective, this company type benefits most from accelerating depreciation under section 179 and bonus depreciation, resulting in an immediate 35% reduction to taxable income. Although the refundable AMT credit may be available to this company type, it is more likely the company will claim the imme-

into account before claiming the incentive opportunities available from the acts.

Claiming a refund. Generally, businesses that are not corporations (including sole proprietorships filing Schedule C with their Form 1040) may accelerate a refund by using Form 1045, *Application for Tentative Refund*. Corporations may also accelerate a refund by using Form 1139, *Corporation Application for Tentative Refund*. The IRS will work to issue refunds generally within 45 days. Applicable amended returns also may be filed during a specific time frame allotted by the IRS. The typical three-year federal statute of limitations is generally waived during this time to allow businesses the full five-year carryback opportunity. Specific instructions related to claiming these benefits likely will be issued by the IRS in the near future.

Audit considerations/Schedule UTP. The IRS monitors research credit refund claims, so companies that claim the credit should maintain adequate documenta-

The typical three-year federal statute of limitations is generally waived to allow businesses the full five-year carryback opportunity.

diate depreciation benefits rather than the in-lieu-of-bonus-depreciation AMT refundable credit, which may take some time to monetize through refund claims.

To the extent this company type does not utilize federal research (or other federal general business) credits during 2010, it likely will pursue additional cash flow by applying the 2010 federal credit to any AMT liabilities in the prior five tax years.

For all three company types described above, monetizing the 2010 federal research (and other federal general business) credit via the five-year carryback could result in an ASC 740-10 (formerly FIN 48) liability, to the extent a reserve has been established for the underlying credits.

CONSIDERATIONS BEFORE CLAIMING BENEFITS

Important considerations should be taken

tion to support their positions. In addition, for tax years beginning in 2010, Schedule UTP will be required for C corporations (individuals and pass-through entities are currently exempt) with assets exceeding \$100 million for 2010. The schedule requires detailed disclosure of a business's uncertain tax positions related to income tax (similar to ASC 740-10 disclosures but much more detailed). Therefore, if any uncertainty exists related to the underlying research credits' monetization via the five-year carryback, this uncertainty will be disclosed on Schedule UTP included with the 2010 federal income tax return. Although the IRS has publicly stated that it will not use the Schedule UTP as an "audit roadmap," such information is undeniably available to the IRS for whatever purpose it deems necessary, including federal audits. ♦

AICPA RESOURCES

Publications

- *The Small Business Jobs Act of 2010: Tools, Tips, and Tactics* (CD-ROM) (#091052HS)
- *The Tax Relief and Job Creation Act of 2010: Tools, Tips, and Tactics* (CD-ROM) (#091057HS)

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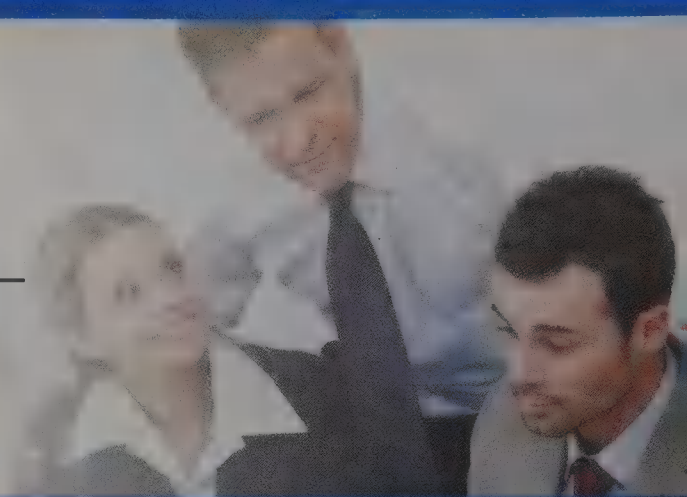
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HOW TO LAND AN SBA Loan

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With all of the uncertainty around maintaining a predictable flow of capital to businesses, a commercial loan provided by a bank but guaranteed by the federal government almost sounds too good to be true. Standing behind such loans is one of the responsibilities of the U.S. Small Business Administration's (SBA) Guaranteed Loans Program.

Application OVER

So, why do many businesses intentionally bypass the SBA and take their chances through the normal commercial bank underwriting process? This article examines the pros and cons of major SBA loan programs and helps CPAs determine if an SBA loan is the best alternative.

UNDERSTANDING SBA LOAN PROGRAMS

The SBA offers several primary loan programs geared toward supporting different aspects of the small business community. To qualify as a small business under current law, a business must demonstrate that it has less than \$15 million in tangible net worth and two years' net income after taxes of less than \$5 million. From this point, various SBA programs have other qualification criteria. Here are summaries of the most popular programs:

7(a) LOAN PROGRAM

This is the SBA's primary and most flexible loan program, with financing guaranteed for a variety of general business purposes. Under this program, the SBA guarantees loans made by participating commercial lending institutions. Possible loan maturities are available up to 10 years for working capital and generally up to 25 years for fixed assets.

504 LOAN PROGRAM

This program provides long-term, fixed-rate financing for expansion or modernization. It is backed by the SBA but delivered by Certified Development Companies (CDCs)—private, nonprofit corporations set up to contribute to the economic development of their communities.

Proceeds from 504 loans must be used for fixed-asset projects, such as:

- Purchasing land and improvements, including existing buildings, grading, street improvements, utilities, parking lots and landscaping.
- Constructing new facilities or modernizing, renovating or converting existing facilities.
- Purchasing long-term machinery and equipment.

The 504 program cannot be used for working capital or inventory, consolidating or repaying debt, or refinancing. Interest rates on 504 loans are pegged to an increment above the current market rate for five-year and 10-year U.S. Treasury issues. Maturities of 10 years or 20 years are available. Fees total approximately 3% of the debenture and may be financed with the loan. Generally, the project assets being financed are used as collateral. Personal guarantees from the principal owners are required.

MICROLOAN PROGRAM

This program provides small, short-term loans for working capital or the purchase of inventory, supplies, furniture, fixtures, machinery and/or equipment. It is designed for small businesses and nonprofit child care centers and is delivered through specially designated intermediary lenders (nonprofit organizations with experience in lending and technical assistance).

Loan terms vary according to the size of the loan, the planned use of the funds, the requirements of the intermediary lender, and the needs of the small business borrower. The maximum term al-

grams for federal government projects, provides incentives for exporters, offers a variety of small business tax breaks, and includes some revenue raisers. For more on the changes resulting from the bill, see the *JofA* articles "Act 2 for Business Tax Incentives" (this issue, page 28) and "Highlights of the Small Business Stimulus Act" (Dec. 2010, page 26).

WHY CONSIDER AN SBA LOAN?

For many businesses, the benefits of an SBA-guaranteed loan include having access to capital where traditional commercial loans may not be available. Startups and young businesses without a sustained history of financial performance may find an SBA-guaranteed loan especially attractive. For businesses with cash flow issues, an SBA loan can restructure debt at better terms by providing longer loan maturities and lower payments. Businesses without sufficient collateral to obtain a traditional commercial loan may find an SBA loan particularly useful.

"It is very difficult at this time for lenders to underwrite the strength and long-term viability of a borrower's ability to repay the

In general, applying for an SBA loan requires more information and more time than a commercial alternative.

lowed for a microloan is six years. Interest rates vary, depending on the intermediary lender and costs to the intermediary from the U.S. Treasury. Generally, these rates will be between 8% and 13%. Each intermediary lender has its own lending and credit requirements. Generally, intermediaries require some type of collateral and the personal guarantee of the business owner.

In recognition of the important role small business plays in a healthy economy, lawmakers passed the Small Business Jobs Act of 2010 (PL 111-240), which expands loan programs through the SBA, strengthens small business preference pro-

posed debt. In this unusually challenging economic cycle where real estate values are declining, it is also difficult to ascertain the future value of collateral," said Jan Roberts of Capital Solutions, a firm based in Birmingham, Ala., specializing in SBA loan advisory services. "SBA provides the backup 'insurance' in order to be able to service the borrower's loan needs." Capital Solutions is managed by Roberts, Nicole Reed and Mike Vance, who are loan originating agents for Foundation Capital and other SBA CDCs.

According to Roberts, the "SBA can also entice a lender to stretch out the terms of a loan. For permanent working

capital, for instance, lenders normally do not want to offer longer-term loans. Under the SBA 7(a) program, however, the lender may be comfortable with a seven-to-10-year term. This serves to lower monthly payments, which benefits the borrower."

WHAT ARE THE DRAWBACKS?

If the federal government is willing to guarantee a substantial portion of a company's debt at favorable terms, why choose traditional commercial lending over an SBA loan? In general, an SBA loan requires more information than a commercial alternative and more time. Also, there is a perception of complexity in maneuvering through the various SBA loan programs. "The real difference between an SBA loan and a conventional bank loan is paperwork," Roberts said.

The SBA process can be time-consuming, said Rachel Zippwald, a California Bank & Trust vice president and SBA lender. For planning purposes, applicants can request a time estimate from the SBA for consideration of the loan.

Roberts cautioned that it is important to remember that SBA loan guarantees are not automatic. SBA loans are underwritten the same way as conventional loans. "We often tell borrowers and lenders that an SBA guarantee does not make a bad loan good.

"Companies experiencing financial distress may be eligible for assistance, but may not be approved for the financing due to lack of reasonable assurance of repayment ability," she said. "SBA can decline loans because they are determined

to be bad credit risks. Credit history plays a big role in those decisions."

Also consider that some businesses are ineligible by definition for SBA loans. Nonprofit organizations, lenders, passive businesses (developers and landlords that do not actively use or occupy the assets acquired with SBA loan proceeds), life insurance companies, and private clubs that limit membership are examples of ineligible businesses. Additionally, SBA loans can require guarantee fees that do not apply to conventional commercial loans. Depending on the amount borrowed, these fees can be significant.

WHAT YOU'LL NEED TO APPLY

Many businesses first discuss the pros and cons of an SBA loan with a loan officer at a commercial bank. Dan Bundy, a vice president at Regions Bank who has specialized in SBA lending during his 25-year career, suggested approaching SBA financing in the same manner as any other loan request. Be proactive with your banker and provide as much information as possible. Educate your banker on the product or service for which you need funding. Discuss the market, the competition and the risks, as well as the mitigating factors involved in your business.

"It goes a long way in giving some comfort to the fact that the project has been thoroughly researched," Bundy said. He suggests including a presentation on available collateral, debt schedules and projections broken out on a monthly basis for the first year and at least two more year-ends.

Detailed assumptions should be given

for the projections, Roberts added.

Include a cash budget, especially when considering a line of credit. "This allows a banker to understand the flow of funds and the timing of cash drains or surpluses," Bundy said, adding that financial statements with notes "give a level of confidence in the numbers" and speak to the effort that the borrower has gone to seek outside financial advice. "Knowing my borrower is interested in help and has been willing to invest in a good CPA for that help tells me that the borrower is not afraid to ask for advice and wants to use every tool to succeed," he said.

The SBA will review a minimum of three years of business tax returns, three years of personal returns for each owner with an ownership stake of 20% or more (for personal guarantee requirements), current business and personal financial statements, and resumes on borrowers as well as key managers.

Zippwald suggested that for key positions that have not been filled, applicants include a thorough job description listing the skill set and experience of the candidate the company is seeking. "This will confirm for the lender that you have analyzed your needs and have determined the requirements of the position," she said.

Business plans are critical, and Roberts added that a well-constructed business plan should include a clear statement of the total capital requirements of the business. It should "explain the source of the equity contribution for the business and the uses of the requested loan proceeds. The business plan should have supporting

EXECUTIVE SUMMARY

■ **Approach SBA financing the way you would any other loan request.** Be proactive with your banker and provide as much information as possible.

■ **Educate your banker on the product or service** for which you need funding. Discuss the market, the competition, the risks, as

well as the mitigating factors involved in your business.

■ **The SBA will want to see at least three years of business tax returns and personal returns** for each owner with an ownership stake of 20% or more (for personal guarantee requirements), current business and

personal financial statements, and resumes on borrowers as well as key managers.

■ **Develop a short list of SBA-friendly banks** early in your research. If one bank rejects an application, another financial institution may see the matter differently.

Ron Box (rbox@joemoney.com) is the CFO of Birmingham, Ala.-based Joe Money Machinery Co.

To comment on this article or to suggest an idea for another article, contact Kim Nilsen, editorial director, at knilsen@aicpa.org or 919-402-4048.

information such as a feasibility study, or demographic analysis and defined target markets with a marketing plan for how to achieve sales."

The SBA requires collateral to fully secure a loan, to the extent that it is available. "If you own a home, you will likely be asked to pledge it," Zippwald said. The SBA may also request a lien on business assets and may require life insurance on sole owners of a business. "Most loans made by banks are secured loans, and therefore approval may be contingent on a guarantor who is willing to offer collateral," she said.

LANDING THE LOAN

Once you have gathered the information required for SBA loan processing, the next step is to determine the financial institutions that have an appetite for SBA loans. Some banks are more reluctant than others when it comes to SBA loans. Try to find out which banks underwrite the most SBA loans in your area and make a short list of potential lenders. Next, make an appointment with a commercial loan officer, and be sure to tell him or her that you would like to discuss an SBA loan.

Selling the bank on the viability of your proposal is the most important aspect of securing an SBA loan. Without the bank's approval, there can be no SBA loan, so rehearse before the meeting.

The bank will have to ensure that all SBA conditions and required documents are in order, otherwise its SBA guarantee claim may be denied. If the bank believes that the extension of credit is not a sound decision, the process will go no further. This is why you need to develop a short list of SBA-friendly banks early in your research. Another financial institution may see the matter differently.

Once the bank approves the underwriting and ensures that all SBA requirements have been met, the package is sent to the SBA for review. If the SBA approves the bank's request for a loan guarantee, the funds will be disbursed as soon as possible.

SHOULD YOU CHOOSE SBA?

The decision to pursue an SBA credit application is not necessarily an easy one. There are many factors to consider, including which programs to pursue, eligibility, fees, loan limits, collateral and other fundamental issues. An SBA loan could be beneficial to your business or a client's business, and CPAs should be well-informed about how to analyze each program's benefits and drawbacks. For specific information, see your commercial lender's SBA group or a firm that provides SBA advisory services. In these times of uncertain credit, you may find that an SBA loan could make the difference between life or death for a business. ❖

AICPA RESOURCES

JofA articles

- "Act 2 for Business Tax Incentives," March 2011, page 28
- "Highlights of the Small Business Stimulus Act," Dec. 2010, page 26

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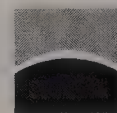
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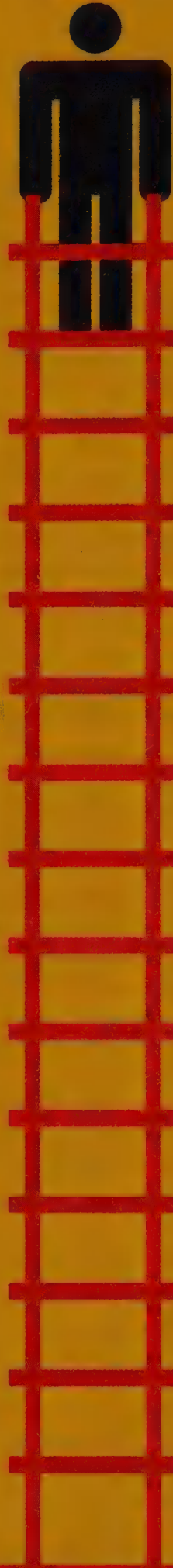
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Corporate Finance Salary Outlook

Robert Half report
predicts return to modest
pay gains in 2011.

by Connie R. Gentry



In corporate finance these days it pays to specialize. A look at anticipated starting salaries for 2011 shows positions that are more niche than generalist in flavor are likely to see the biggest pay gains compared with 2010.

"The more specialized you are, the more desirable you are," said Carol Scott, CPA, vice president—Business, Industry & Government for the AICPA. "The greater opportunity for finance professionals is in specialized roles: regulatory compliance, tax accountants, fraud and forensic accountants."

The largest projected increase in the *2011 Salary Guide* published by Robert Half International (RHI) for corporate finance positions is a 5% climb for senior business analysts, who could see starting pay ranging from \$66,500 to \$85,500. (See Exhibit 1; the *2011 Salary Guide* can be downloaded from roberthalf.com/salarycenter.)

Across all corporate finance job titles, the starting salary forecast for this year is sunnier than it was in 2010. Robert Half predicted an average increase of 3.1%—a significant improvement over last year's negligible 0.6% rise. See Exhibit 2 for data on other positions of interest.

Historical trends reflected in the guide, which has been published every year since 1950, suggest the industry may be recovering from the economic crisis at a faster rate than it did after the burst of the dot-com bubble. During the technology run-up, the *2001 Salary Guide* predicted a 7.2% increase in the average starting salaries for finance and accounting professionals employed in corporate positions. But by 2002, the forecast was a modest 1.5% increase, and in the next two years the Robert Half guides predicted starting salaries would decrease year over year, dropping 0.3% in 2003 and another 1.1% in 2004. It wasn't until the 2006 forecast, five years after the onslaught of that recession, that accounting and finance starting salaries in corporate settings were expected to increase 3.1%, the same average projected for 2011.

"Accountants are more critical to business than they've ever been," said Dawn Fay, district president for Robert Half's New York/New Jersey market. "Not much changed in accounting for a long time, but then Sarbanes-Oxley happened, new regulations came out of this last downturn, and there has been growing emphasis on the integrity of data and [an undercurrent] of corporate mistrust. All of these factors put added pressure on accounting and finance to report accurate numbers and maintain excellent business practices."

The RHI survey suggested jobs would be added across all levels of corporate finance, Fay said. The challenge, she said, is finding candidates with diverse capabilities, from technical expertise to systems knowledge and soft skills. "Employers need individuals with strong communications skills who can articulate forecasts and report numbers in meetings," she said.

HOT JOBS

Business analysts are among the most sought-after corporate finance

Exhibit 1 Corporate Accounting's Largest Projected Salary Increases for 2011

Position	Projected increase over 2010 levels
1. Senior business analyst	5.0%
2. Tax accounting manager, midsize company	4.9%
3 (tie). Financial analysis manager, large company	4.8%
3 (tie). Financial analysis manager, midsize company	4.8%
3 (tie). Tax accounting manager, large company	4.8%
6 (tie). Senior financial analyst, midsize company	4.7%
6 (tie). Tax accountant (1 to 3 years of experience), midsize company	4.7%
8 (tie). Financial analyst (1 to 3 years of experience), midsize company	4.6%
8 (tie). Forensic accountant	4.6%
8 (tie). Senior tax accountant, large company	4.6%

Large companies = \$250+ million in sales; midsize companies = \$25 million to \$250 million in sales; small companies = up to \$25 million in sales.

Source: Robert Half International, *2011 Salary Guide*.

professionals, according to Robert Half. Companies of all sizes are seeking business analysts at every level, largely because these positions marry technology and accounting.

"This is the person who bridges the gap between emerging technologies, internal computer systems, and accounting and finance," Fay said. Ideally business analysts leverage the technology infrastructure to drive the company's efficiencies and profitability.

For 2011, business analysts in businesses of all sizes can expect starting salaries and year-over-year increases as follows:

- Entry level, up to 1 year of experience:
\$43,000 to \$55,000 4% increase
- Junior level, 1 to 3 years of experience:
\$51,000 to \$68,750 4.4% increase
- Senior level:
\$66,500 to \$85,500 5% increase
- Manager level:
\$78,250 to \$102,500 4.5% increase

Financial analysts are likewise in high demand, especially at midsize companies (\$25 million to \$250 million in sales) and at large companies (sales exceeding \$250 million), according to the *2011 Salary Guide*, primarily because identifying opportunities to increase profits is a priority for companies.

"Before a company can launch a new product or expand its services, it has to do extensive research to see if the numbers make sense,"

Fay said. "Financial analysts identify what the business should be doing to perform ahead of competitors."

Predicted starting salaries for financial analysts for 2011 are expected to fall within the following ranges (with the year-over-year increase noted as well):

■ Entry level, up to 1 year of experience:			
Midsize companies:	\$39,500 to \$48,000	4.5% increase	
Large companies:	\$41,000 to \$51,750	4.2% increase	
■ Junior level, 1 to 3 years of experience:			
Midsize companies:	\$46,750 to \$61,500	4.6% increase	
Large companies:	\$50,000 to \$66,250	3.6% increase	
■ Senior level:			
Midsize companies:	\$60,000 to \$78,000	4.7% increase	
Large companies:	\$66,000 to \$85,250	4.5% increase	
■ Manager level:			
Midsize companies:	\$72,750 to \$95,000	4.8% increase	
Large companies:	\$81,500 to \$109,750	4.8% increase	

Tax accountants also are hot properties. "Becoming compliant with all of the new accounting regulations, particularly FIN 48, has driven the need for tax accountants. Although these [professionals] are always critical to businesses, the new standards have escalated the need for tax specialists," Fay said.

For tax accountants, predicted 2011 starting salaries and the increase over 2010 are:

■ Entry level, up to 1 year of experience:			
Midsize companies:	\$40,250 to \$49,000	4.4% increase	
Large companies:	\$41,500 to \$51,250	4.2% increase	
■ Junior level, 1 to 3 years of experience:			
Midsize companies:	\$46,000 to \$59,250	4.7% increase	
Large companies:	\$48,500 to \$64,250	4.4% increase	
■ Senior level:			
Midsize companies:	\$54,750 to \$73,500	4.5% increase	
Large companies:	\$65,250 to \$82,500	4.6% increase	
■ Manager level:			
Midsize companies:	\$69,500 to \$92,500	4.9% increase	
Large companies:	\$81,250 to \$108,750	4.8% increase	

PROJECTIONS FOR CFOs AND OTHER POSITIONS

Among CFOs, starting salaries are expected to increase this year from 1.8% (in companies with sales under \$50 million) to 3.3% (in companies with sales of \$250 million to \$500 million).

For controllers—who are in high demand as companies work to enhance accounting and internal control systems and assist with growth initiatives—starting salaries should increase an average of 2.9% across companies of all sizes, the Robert Half survey said.

Although pay will fluctuate depending on the individual's experience and the company's size, starting salaries for general accountants will increase an average of 3% in small companies with sales under \$25 million, as well as in larger companies with sales exceeding \$250 million. However, starting salaries for general accountants are projected to increase more substantially, on average 4%, in midsize companies (sales of \$25 million to \$250 million).

Across the spectrum of all companies, senior accountants can expect starting salaries from \$47,750 to \$76,250; junior accountants, with one to three years of experience, will start at \$38,750 to \$59,500.

Positions with the lowest anticipated increases in starting salaries, ranging from 0.7% to 1.8%, include the treasurer and vice president of finance across companies of all sizes, as well as credit and collections associates in small companies.

The report reflects national average starting salaries across a spectrum of finance and accounting positions and is based on thousands of job placements managed by Robert Half. The ranges and projected increases do not include bonuses, incentives or other benefits included in a total compensation package. Additionally, the report does not distinguish CPA vs. non-CPA salaries except to note those individuals with professional certifications or graduate degrees can earn an average of 5% to 10% more than the listed figure when the position does not inherently assume advanced degrees or professional certification. "Even if a job description doesn't specify CPA as a requirement, being a CPA will get you in the right stack on the recruiter's desk, and it will get you greater compensation, in some cases 10% to 15% higher," said the AICPA's Scott.

THE JOB MARKET

Despite signs of wage traction, it is still an employer's market, observers said. "What I'm hearing in the marketplace is that things are easing a bit for finance and accounting professionals, but overall it's still pretty tight, and starting salaries aren't as high as they once were," said Scott. "Companies will give small salary increases, and those that are prospering will also give bonuses."

Among unemployed or underemployed finance and accounting

EXECUTIVE SUMMARY

■ **Across all corporate finance job titles**, Robert Half International predicts a 3.1% increase in starting salaries for 2011. That year-over-year progress is up considerably from last year's 0.6% forecast.

■ **The largest projected climb**

for corporate finance positions in Robert Half's 2011 *Salary Guide* is 5% for senior business analysts, who could see starting pay ranging from \$66,500 to \$85,500.

■ **Other jobs showing strong year-over-year salary increase**

predictions include financial analysts and tax accountants.

■ **Among CFOs, starting salaries are expected** to increase this year from 1.8% (in companies under \$50 million) to 3.3% (in companies with sales of \$250 million to \$500 million).

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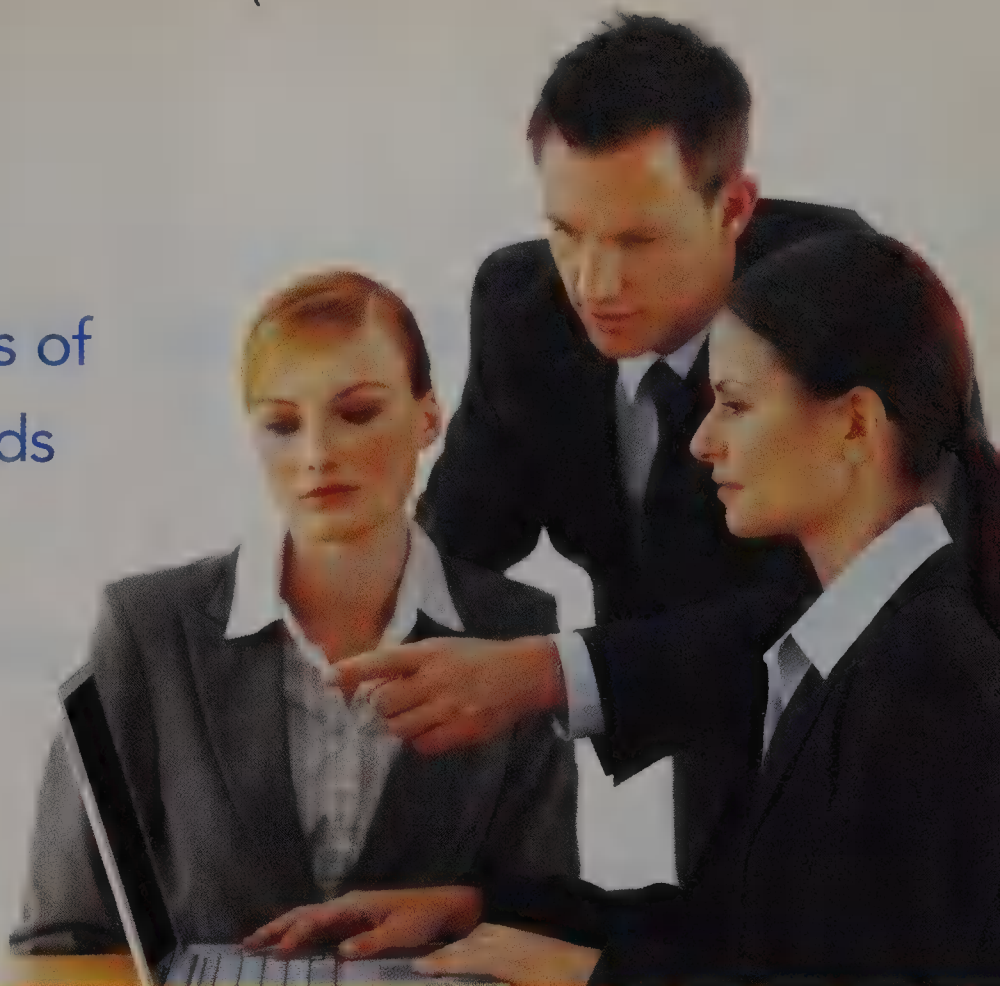
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Exhibit 2 Positions of Interest

Chief Financial Officer

Company sales in millions	Salary range	Projected increase over 2010 levels
\$500+	\$271,250 to \$395,500	2.3%
\$250 to \$500	\$187,750 to \$265,250	3.3%
\$100 to \$250	\$129,500 to \$182,250	3.1%
\$50 to \$100	\$107,500 to \$148,250	2.2%
Up to \$50	\$94,250 to \$130,500	1.8%

(The category assumes there is a corporate controller who reports to the CFO.)

Controller

Company sales in millions	Salary range	Projected increase over 2010 levels
\$500+	\$132,750 to \$175,250	2.9%
\$250 to \$500	\$110,000 to \$147,500	2.7%
\$100 to \$250	\$94,250 to \$124,750	2.9%
\$50 to \$100	\$77,750 to \$105,750	3.2%
Up to \$50	\$67,000 to \$91,000	2.9%

General Accountant: Large Companies

Position	Salary range ²	Projected increase over 2010 levels
Manager	\$73,750 to \$100,000	2.8%
Senior	\$58,250 to \$76,250	3.7%
1 to 3 years of experience	\$45,750 to \$59,500	2.9%
Up to 1 year of experience	\$38,500 to \$47,750	2.7%

General Accountant: Midsize Companies

Position	Salary range ²	Projected increase over 2010 levels
Manager	\$63,500 to \$83,500	4.4%
Senior	\$52,750 to \$68,500	3.9%

General Accountant: Midsize Companies (cont.)

Position	Salary range ²	Projected increase over 2010 levels
1 to 3 years of experience	\$42,000 to \$55,500	3.7%
Up to 1 year of experience	\$36,500 to \$45,250	4.1%

General Accountant: Small Companies

Position	Salary range ²	Projected increase over 2010 levels
Manager	\$57,750 to \$75,500	3.3%
Senior	\$47,750 to \$61,250	3.1%
1 to 3 years of experience	\$38,750 to \$50,500	2.9%
Up to 1 year of experience	\$34,000 to \$41,250	2.7%

Tax Accountant: Large Companies

Position	Salary range ²	Projected increase over 2010 levels
Manager	\$81,250 to \$108,750	4.8%
Senior	\$65,250 to \$82,500	4.6%
1 to 3 years of experience	\$48,500 to \$64,250	4.4%
Up to 1 year of experience	\$41,500 to \$51,250	4.2%

Tax Accountant: Midsize Companies

Position	Salary range ²	Projected increase over 2010 levels
Manager	\$69,500 to \$92,500	4.9%
Senior	\$54,750 to \$73,500	4.5%
1 to 3 years of experience	\$46,000 to \$59,250	4.7%
Up to 1 year of experience	\$40,250 to \$49,000	4.4%

1. Large companies = \$250+ million in sales; midsize companies = \$25 million to \$250 million in sales; small companies = up to \$25 million in sales.

2. Add 5% to 10% for graduate degrees or professional certifications.

Source: Robert Half International, 2011 Salary Guide.

professionals, those over 50 who were previously in senior-level positions are having the hardest time finding jobs. The tight job market is the biggest factor, but another contributor is that senior-level finance professionals can and do remain in positions beyond typical retirement age, said Matt Bud, chairman of The Financial Executives Networking Group (The FENG), a global networking organization with more than 38,000 members. To join The FENG, financial professionals (predominantly CFOs, controllers, treasurers, vice presidents of finance, tax, etc.) must earn at least a six-figure annual salary and have 15 or more years of experience (most have more than 20 years of experience).

The FENG sends daily e-mails of potential job opportunities to its members. "Eighteen months ago, I was sending 100 pages each Sunday, now we're lucky to have 30 pages," Bud said. Another factor hampering a seasoned CFO's search for new employment is that, while many were previously with a large company, chances of returning to a large corporation are slim since larger companies typically promote from within. Bud suggested senior executives might find more opportunities in middle market firms and small startups that need the expertise—although salaries in that realm might not compare to what senior executives are accustomed to.

Securing a job requires more open-minded flexibility than in the past. The hottest job markets may require relocation, and starting

salaries can fluctuate dramatically between local markets. For instance, a CFO joining a small company in Dallas could expect a starting salary between \$98,963 and \$137,025, according to Robert Half, but in Detroit the same CFO's starting salary at a small company would range from \$91,046 to \$126,063. (See, "Customizing Salaries for Local Markets," page 19 of the *2011 Salary Guide*.)

Based on RHI's research, the most promising regions for job growth are the West South Central and, to some extent, the Pacific region. CFOs seemed most optimistic about hiring in Arkansas, Louisiana, Texas and select areas of California and Oregon. Financial services, manufacturing and health care are among the more active industries for job openings. ♦

AICPA RESOURCES

Conference

AICPA National CFO Conference, May 19–20, Boston

For more information or to register, go to cpa2biz.com or call the Institute at 888-777-7077.

Website

To see the latest results of the AICPA/UNC Kenan-Flagler Business and Industry Economic Outlook Survey, go to tinyurl.com/2a2hfyr.



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...the go-to business guide for on-the-go accounting professionals

Need to answer client questions fast? Simply type your topic into the **Accountant's Business Manual** online search box and get:

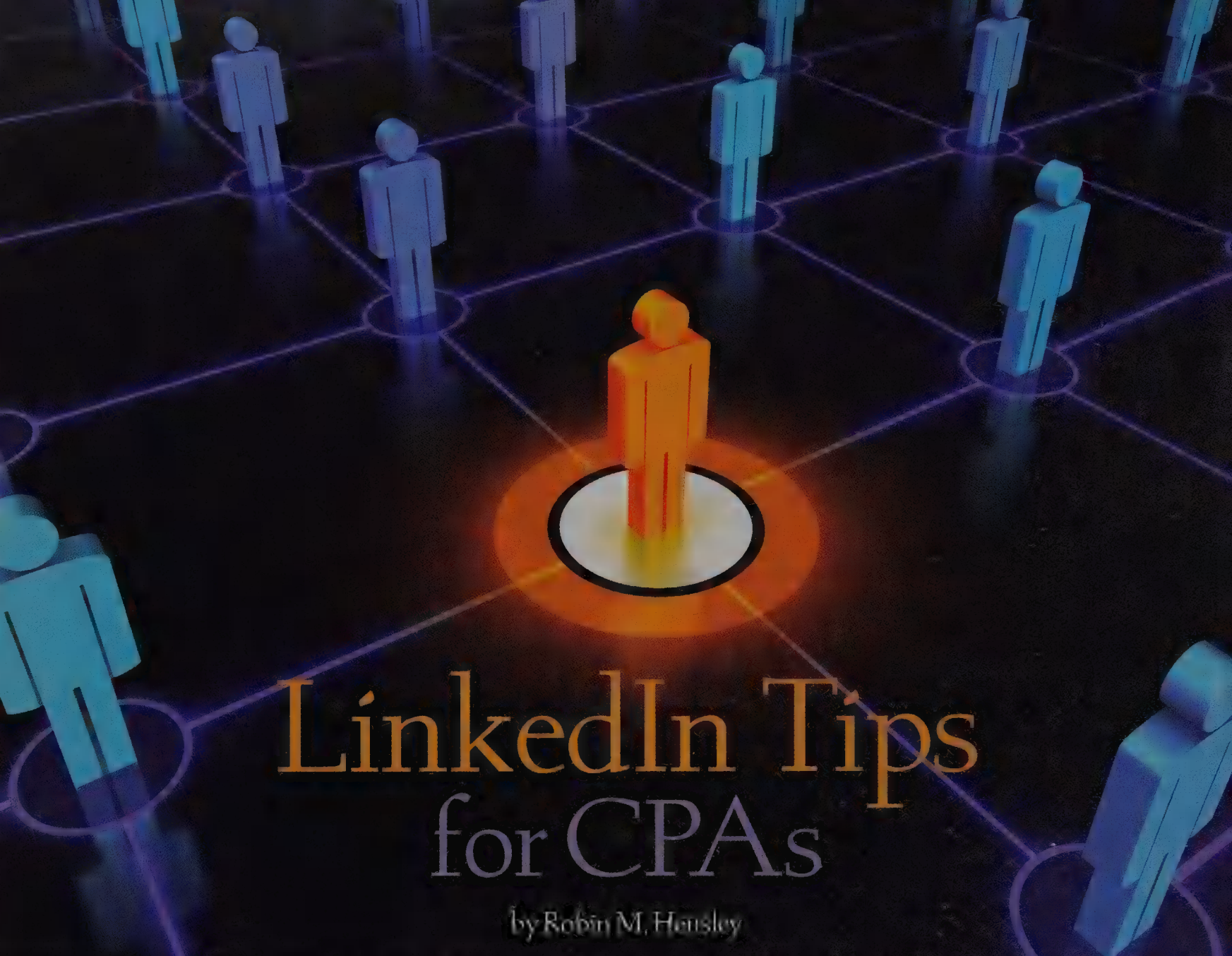
- Expert commentary from renowned authors:
 - **Sid Kess**, JD, LL.M., CPA
 - **Barbara Weltman**, JD
 - **Bill Behrenfeld**, JD, LL.M., CPA
- Concise summaries of critical business, legal, tax, and financial topics — including all of the provisions of the recent Tax Act, plus a brand new chapter on healthcare and small businesses. You'll find the information you need to answer business and industry specific questions with authority
- Hundreds of time-saving forms, checklists, sample letters and interactive worksheets you can download and use immediately
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CPA Client — A Review of the Small Business Jobs Act of 2010



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LinkedIn Tips for CPAs

by Robin M. Hensley

Say you run a small accounting practice but are not a marketing expert. What can you do to build your business that's easy, quick and inexpensive? The answer is LinkedIn.

The LinkedIn platform is designed specifically for business use. It is the social media of choice for more than 90 million users around the world. Executives from virtually every *Fortune* 500 company are represented. But LinkedIn is not just for the big guys. Sole practitioners and small practices can leverage its power, too, to reach a wider audience.

Following are 10 tips accountants can use for accelerating connections and achieving new business successes via LinkedIn. (Those less familiar with LinkedIn's basic functionality can refer to "Are You Linked In?" in this issue on page 48.):

1. **Make your profile complete using accounting language derived from your firm's marketing materials, brochures or company profile.**

The more detailed and descriptive your summary and specialty profiles are, the easier it will be for someone searching for

your expertise to find you. Identify keywords by asking yourself, "What is my client prospect looking for? What search words might he or she use to look for me?" Take your lead from your firm's marketing materials and firm profile and incorporate some of that language. For example, if you are a forensic accountant, you will certainly want to include that term in your profile. In my case, I include keywords that are likely to be searched on when describing my services as shown in the screenshot below.

Specialties

While Robin's primary clients are attorneys and CPAs, she also works with executives, professionals and entrepreneurs in a wide variety of industries in these practice specialties.

- Business Development Coaching
- Career Coaching
- Executive Coaching

2. **Search for CFOs or tax directors by title to research new business targets.**

Save time searching for new business targets by using the **Advanced People Search** feature, which you access by clicking on the word **Advanced** next to the search box in the upper-right corner of any page. You can find almost anyone by entering a

job title, keyword or phrase. For example, you can enter “CFO” or “Tax Director.” You can narrow your search by adding a city, state, country, industry, company or school, as shown in the screenshot below.

If you want to win new clients in the international import/export trade, for example, you might use “CFO import export” as your search term.

Can't find what you are looking for? More extensive searches for categories such as seniority level, years of experience and company size can be done with a premium membership.

3. Conduct competitive intelligence research on current accounting clients, targets, referral sources, etc.

Losing a client hurts. It is especially painful when you might have prevented the loss if you had just known more about that client's situation. Using LinkedIn to follow your clients and their companies will help you research and stay current. LinkedIn helps you keep track of your list and makes it easy to add, change or delete your settings.

For example, if a client acquires a new subsidiary, you will know as soon as it happens and can respond quickly with relevant services your firm offers.

The **Follow** feature also works well for target clients, referral sources or companies you'd like to know more about. You can track new hires and watch general industry trends, too.

You can follow anyone in a group in which you both have a

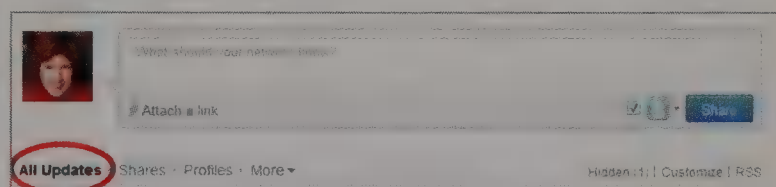
membership. To follow a company, you can click on any company your connection lists in his or her profile, or you can visit the company profile of any company you want to follow and click on the **Follow Company** icon.

4. Use LinkedIn Jobs to forward accounting jobs to friends, track those in new positions and send congratulatory notes, etc.

One of LinkedIn's major functions is to help people find work. The **Jobs** section allows you to look for work for yourself and/or post a position open at your firm. (There is a fee for listing an open position. That fee varies depending on geographic location. For example, a single 30-day job listing in the Atlanta area costs \$195, according to LinkedIn's **Job Price Calculator**.)

According to LinkedIn, job applicants who are sourced through LinkedIn are of a higher caliber than those who are sourced through the major job boards—something to keep in mind if you are searching for talent for your practice.

You can also forward job opportunities to your friends and associates. When they find new positions and update their profile or status, you will be notified in **All Updates** on your **Home** page and can send them a quick note to say, “Well done!” See the screenshot below for an example.



You will also receive automatic **Network Updates** e-mail alerts unless you opt out of that feature.

“As a profession, we are all trying to bring in younger folks and excite them about the importance of what we do,” said James F. Hart, CPA/ABV/CFE, MBA, CIRA, CFE, and managing member at Lightfoot Group LLC in Atlanta. “To find them and get them involved, we need to go where they go and be where they are, ♦

EXECUTIVE SUMMARY

■ **LinkedIn can serve as a useful tool for accountants to grow their businesses and stay on top of industry trends**, whether they are sole practitioners or part of a large CPA firm. This and the next article provide tips and examples from firms that have achieved success using this social media outlet as well as instructions on how to get started using it.

■ **Read basic tips for all professionals.** Learn how to start an account, grow your network, join

groups and get recommendations.

■ **Beef up your profile and attract clients.** Identify keywords by asking yourself, “What is my client prospect looking for?” or “What search words might he or she use to look for me?” Take your lead from your firm's marketing materials and firm profile and incorporate some of that language.

■ **Use the Follow feature.** This feature lets you target clients, re-

ferred sources, or companies you'd like to know more about. You also can track new hires and watch general industry trends.

■ **Join accounting-specific groups** and groups that represent your ideal client, reflect your practice specialty and/or your professional and personal interests. All of these groups help you connect with people you want to meet, do business with, and with whom you share common interests. Once you are a group mem-

ber, you can ask and respond to questions, make a comment or take a position on a topic.

Robin M. Hensley (rhensley@raisingthebar.com) is a business development coach and president of *Raising the Bar*.

To comment on this article or to suggest an idea for another article, contact **Alexandra DeFelice**, senior editor, at adefelice@aicpa.org or 212-596-6122.

such as through LinkedIn."

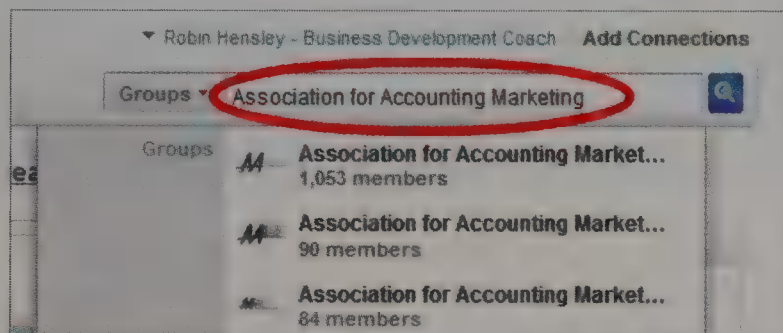
Hart is specifically putting this to work as the section chair for the Georgia Society of CPAs (GSCPA) Forensic & Valuation Services Section. Due to the effectiveness of the section's LinkedIn group in adding value to its members, among other activities, Hart was honored as "Distinguished Member of the Year" by the GSCPA for his achievements in 2009.

"LinkedIn works 24/7 for me as a leader of the GSCPA and in my personal practice," he said. "It doesn't cost us anything. For the section, there is no extra effort to monitor or respond because, whenever any of us are there, we can all jump in."

5. Join accounting-focused LinkedIn groups such as the Association for Accounting Marketing (AAM) and the AICPA's Private Companies Practice Section (PCPS) to get business development tips.

The AAM's LinkedIn group and the AICPA's PCPS offer education and professional development for the specific challenges accounting professionals face as they market their services. Participation in these LinkedIn groups gives you the opportunity to increase your visibility by asking and answering questions as well as raising points for discussion.

You can search for professional groups by selecting "Groups" from the dropdown menu next to the search box in the upper-right corner of any page. See the screenshot below.



6. Join your local accounting society or association's LinkedIn group. Information is vital to success in today's competitive accounting profession. Local accounting association groups keep you in touch with fellow members, keep you up to date on the latest events, and increase your visibility within the association.

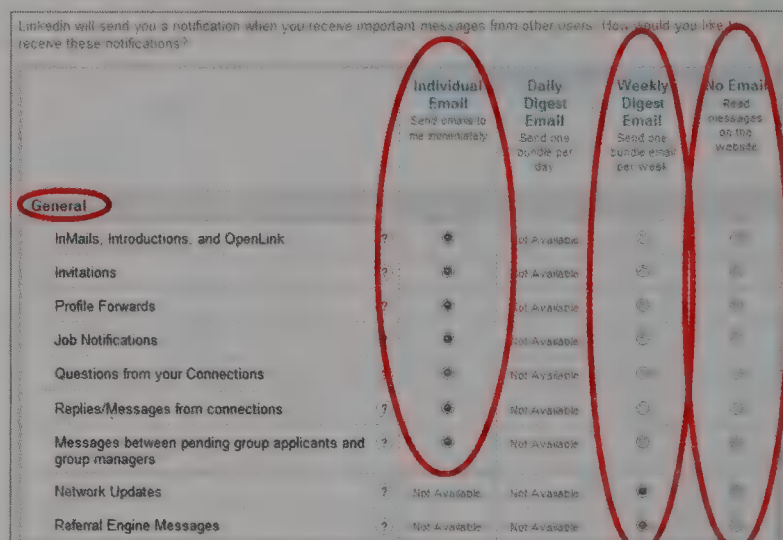
Elizabeth Kistler, public relations manager for the GSCPA, said, "The GSCPA LinkedIn group is growing larger and faster than any of our other social media outlets. ... It proves that GSCPA members are joining and using LinkedIn to advance their professional careers."

"The group now includes 844 of our total of nearly 10,000 members. In other words, 8.5% of our membership is now connected through the site," she said.

You should also join other LinkedIn groups that allow free group participation even if you don't belong to their association. Consider groups that represent your ideal client, reflect your practice specialty and/or your professional and personal interests. All

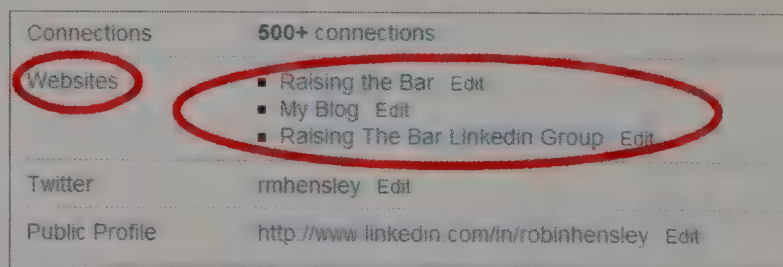
of these groups help you connect with people you want to meet, do business with, and with whom you share common interests.

Once you are a group member, you can ask and respond to questions, make a comment or take a position on a topic. For example, a recent hot topic in the GSCPA group centered on studying for the CPA exam and which publishers did the best job with their study materials. That discussion generated a number of information-rich responses and tips. LinkedIn's weekly e-mail updates will keep you alerted to hot topics in the profession your group serves. (Weekly updates are automatic unless you opt out. Manage the notifications you receive by clicking on your name in the upper-right corner of any page and selecting **Settings** from the dropdown menu. Then under **Email Notifications**, select **Receiving Messages** to bring up the menu shown below.)



7. Connect your profile to your accounting issues blog and/or your website.

Have you just completed a new blog post or newsletter on the latest fund accounting practices? Linking your profile to your accounting blog or website can be an effective tool for building traffic. You can easily link your blog in the **Edit Profile** section of your profile as shown in the screenshot below.



You can also integrate your WordPress or TypePad blog directly into your profile by adding the appropriate application. (Select **Get More Applications...** from the **More** dropdown menu at the top of any page. Scroll down until you find the WordPress or Blog Link powered by TypePad, click **Add** and follow the prompts.

Add more impact by posting a status update that mentions your latest blog post. For example, if you want to call attention to that blog post or newsletter on fund accounting practices, you could say, "Just posted some tips on Fund Accounting practices on my blog at [www...](#)" or "Just published some tips on Fund Accounting practices in this month's edition of my online newsletter at [www...](#)" You can also attach the link instead of including it in the text.

LinkedIn sends out a weekly update to everyone in your network—another way to reach out to your connections and encourage traffic to your blog. Again, those default settings can be easily changed as described in Tip No. 6.

You don't have a blog or newsletter? You can still link to your website and show any changes in a status update.

8. Join alumni networks for past accounting employers.

Don't overlook your past employers. Connections made through past employment alumni networks are often excellent sources for references, new employees and business referrals. For example, the Ernst & Young Alumni Group has more than 20,000 members.

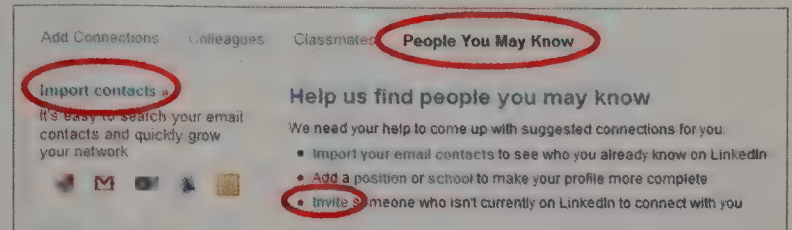
Not a Big Four alum? Your former co-workers at any past employer may have set up a group. Or, why not start one yourself? But before you do, consider checking the company's social media policies first.

Look for these groups by name in the **Groups Directory** or include "alumni" with your search term in the search box.

9. Maintain your marketing effort during busy season, or whatever that season is for your firm, by taking advantage of LinkedIn's ease of use.

Fifteen minutes three times a week on LinkedIn can help you stay on top of marketing even during the busiest times of the year. (One caveat, however. Fifteen minutes can quickly turn into three hours if you're not careful. Watch the clock or set a timer to make sure you stick to your schedule.)

- Minutes 1–5: Do a status update. Have you just landed a new client (no names, of course, unless your client agrees) or achieved a personal best? It only takes a minute, but each posting is far-reaching thanks to LinkedIn's Weekly Updates broadcast. (For more on status updates, see "Make Your Mark With Your Social Media Status" on page 20 in this issue.)
- Minutes 6–10: Browse **All Updates** on your **Home** page. Congratulate a connection or comment on a profile update, even if it's just to say, "Great new photo." All of these comments go out to your entire network.
- Minutes 11–15: Glance through **People You May Know** by clicking on **Add Connections** in the upper-right corner of the **Profile** screen and selecting it from the screen that appears. These are people who are connected to your connections. If you see someone you know, invite him or her to join your network. When your invitation is accepted, **All Updates**, shown on your **Home** page, will reflect that and your new connection will be included in the Weekly Updates broadcast. See the screenshot in the next column.



If 15 minutes three times a week is too much, post just one status update every other day and invite a connection with just one new person a day.

"Stated simply, I always have my LinkedIn page open when I'm at my desk, so that I can watch for updates from my connections," said Thomas L. Jollay, CPA, a shareholder at Bennett Thrasher, a large Atlanta-based accounting, audit and consulting firm. "I also devote 15 to 30 minutes of every day to reaching out through the network. I make notes of people I need to get introduced to in the future and monitor activity of our current clients."

10. **Inspire all of your accounting firm or company accounting department employees to join with you and benefit from the power of a group marketing effort.** Organize LinkedIn training sessions for them so they can get the most out of it for the firm and for themselves.

Don't keep LinkedIn a secret. Invite your associates and employees to participate. Use by multiple employees will bring a multiplier effect to your network activity and increase your online presence exponentially. Be sure to set clear policies on LinkedIn use to avoid nondisclosure and privacy issues, and be sure to provide the proper training so everyone participating will get the most out of his or her efforts. If you don't have time to develop a training program, bring in an outside expert to deliver the training for you.

Jollay and his colleagues have achieved sales results from posting information on LinkedIn about articles they want to draw attention to. "I have definitely had numerous individuals respond to offers for various articles. This has led to in-depth calls about specific needs they may have at present or pending," he said.

Michael Blake, director of Valuation Services at Atlanta-based Habif, Arogeti & Wynne LLP, knows that LinkedIn can lead to concrete results, too. "Through LinkedIn, I have (already) gotten one valuation engagement for \$10,000."

He did this by scanning his targets to see what they were reading. When he noticed that one of them had listed a valuation book on his **Reading List by Amazon** (found by scrolling down the right side of the **Home** page), he reached out, suggested another book and asked if there were any questions he could answer. That contact eventually led to a meeting, and the potential client hired Blake to perform the engagement.

LinkedIn is a highly intuitive and easy-to-use tool that offers access to the people you already know personally and professionally, and the people you want to know. Using these 10 simple tips will help you maximize your time and effectiveness online as you market your services in a shifting and aggressive work climate. ♦

Are You Linked In?

An introduction to the social media tool

by Caroline O. Ford, CPA, Ph.D., and Justin Lim



While LinkedIn provides benefits particularly helpful for accountants, it is important to review all that a free, basic LinkedIn account offers. From profile creation to making connections and recommendations, LinkedIn tools can benefit users in any profession.

CREATING AN ACCOUNT

Getting started with LinkedIn begins with visiting linkedin.com to create a professional profile as shown in the screenshot at right.

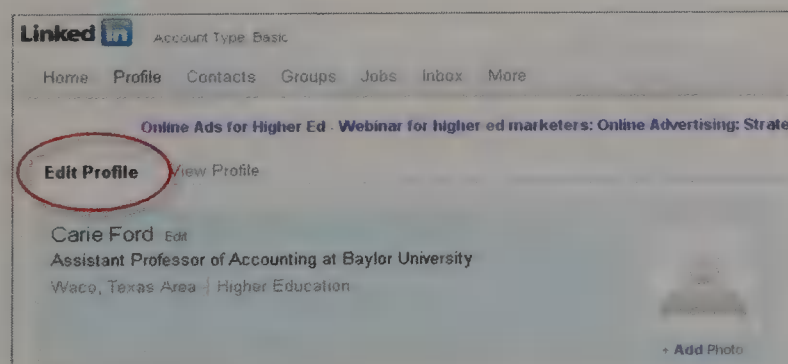
The screenshot shows the LinkedIn sign-up interface. At the top is the LinkedIn logo. Below it is a blue banner with the text "Join LinkedIn, sign up below. It's free!". The form contains four input fields: "First Name:", "Last Name:", "Email:", and "New Password:". Below the "New Password:" field is a small text requirement "6 or more characters". At the bottom of the form is a green button labeled "Join LinkedIn" with a small star icon to its right.

During registration, choose either a free (Basic) account or a premium account. Both allow you to create a professional profile, join groups, and search and apply for jobs. Premium accounts include features such as the ability to see who has viewed your profile, send messages to those you are not connected to, save profiles to folders, and have premium search filters and automated search alerts. A range of premium accounts exists for business owners, recruiters and job seekers. Four premium account levels exist for businesses and recruiters with monthly prices of \$24.95, \$49.95, \$99.95 and \$499.95. Each level has increased features. The chart below provides details, including how many searches, introductions, etc., can be performed at one time. (See the "Connections" section of this article for a description of **InMail** and **Introductions**.)

	Account Type				
	Basic	Business	Business Plus	Executive	Pro
Monthly fee	Free	\$24.95	\$49.95	\$99.95	\$499.95
Send InMail, Monthly	0	3	10	25	50
Saved Searches	3	5	7	10	10
Open Introductions	5	15	25	35	40
Results Per Search	100	300	500	700	1,000
Saved Profile Folders	0	5	25	50	75

PROFILE

After creating an account, choose **Edit Profile** to get started (see the screenshot below). Visible to your network and others searching on LinkedIn, your profile displays your name, experience, education, executive summary and skill set, recommendations and a photo.

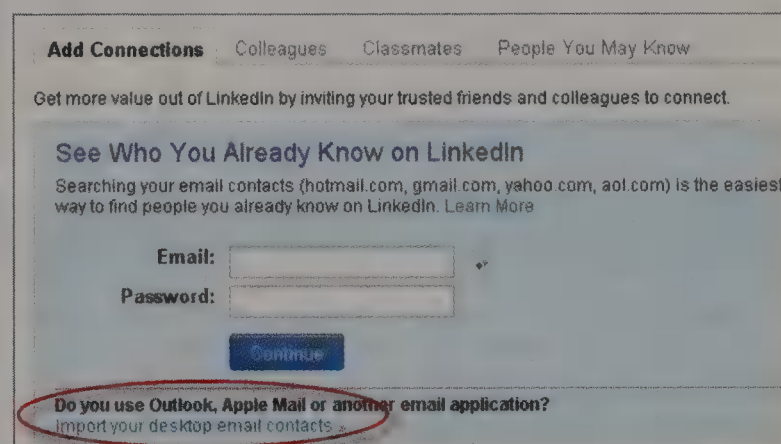


You have the option to display your maiden name or only the initial of your last name to people outside your network. Experience outlines former positions and allows for detailed job descriptions. Specific expertise, accomplishments and goals are described within your executive summary, and recommendations allow you to ask to be endorsed for any position on your LinkedIn

profile. More information on recommendations is explained later in this article.

CONNECTIONS

After creating a profile, start making connections (see the screenshot below). Users can control who joins their network through several means: **Invitations**, **Introductions** and **InMail**. Two users connect when one sends an invitation to the other and the other accepts. LinkedIn will suggest potential connections to invite based on your profile information. For example, using your employment history, LinkedIn lists other members who worked for the same company at the same time. Similarly, LinkedIn finds classmates from your alma mater and/or colleges attended. Additionally, you can import your address book from an Internet-based e-mail account or an Outlook contacts file, manually input e-mail addresses, or use the search feature to find users you know. If your contacts are not already members, a feature allows you to invite them to join. Connections that have accepted are considered first-degree connections.



It is important to carefully screen who you accept as a connection; just as it is important to choose wisely those you invite. If there is someone with whom you would like to connect, but you do not know, consider using the **Introductions** feature available in LinkedIn. Within LinkedIn, second-degree connections are people connected to you through first-degree connections but are not connections to you. The levels of separation reach third-degree connections, followed by those outside your LinkedIn network.

The **Introductions** feature lets you contact members who are two or three degrees away from you. Just as you might call a mutual friend or colleague to introduce you to someone, you can send a LinkedIn introduction request through the connections you know and trust. By visiting the **Profile** page of the individual with whom you want to be introduced, you can request to be introduced through a mutual LinkedIn connection. Your connection (at his or her discretion) can then forward the introduction request. Responding to an introduction does not automatically result in a connection. To become connected, a member must send or accept an invitation using an e-mail address that was shared through the introduction process. The number of introductions

sent is limited based on account type chosen. A Basic LinkedIn account may send five requests at a time. Once the maximum amount of requests is issued, a user must wait for an introduction to be accepted before sending another.

InMail allows you to send messages directly to LinkedIn users who are second or third degrees away from you or outside your network. **InMail** is not necessary for first-degree connections or members of your groups; a **Send message** link allows you to send messages to these members at no charge. **InMail** allows you to contact job candidates, those with whom you do not have a face-to-face relationship, or LinkedIn members whose e-mail address you do not know. **InMail** can be a quicker and simpler alternative to **Introductions**. Sending **InMail** is a paid feature that is part of a premium account or can be purchased individually. Basic accounts can *receive* unlimited **InMails** but incur a fee to send them. LinkedIn charges for **InMail** to prevent spam. Depending on your paid subscription, you can send up to 50 **InMails** per month.

Overall, these methods of communication allow users to reconnect with colleagues and classmates and form new connections through a trusted network. Privacy settings allow members to restrict or allow the kinds of interactions desired, making LinkedIn attractive to motivated, credible professionals while keeping spammers and phishers out.

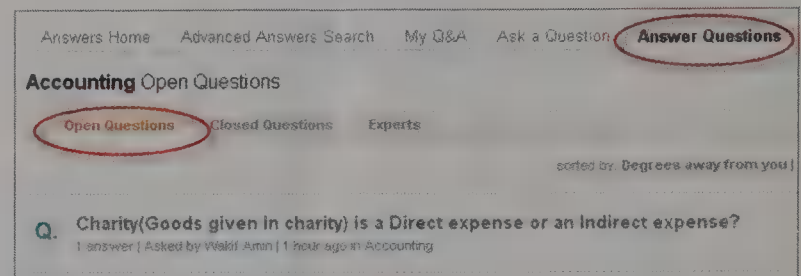
TOOLS

LinkedIn allows users to create and join groups based on interest. Joining groups is an important venue for increasing your profile visibility as well as keeping track of current and former employees, college friends and other alumni. Based on your profile information, LinkedIn will create a list of groups for you in a **Groups You May Like** option on the **Groups** tab. You may also go to the **Groups Directory** and search your industry or by keyword to join a group; once accepted, you can share with the group.

At any time, a click on your photo takes you to your recent activity and links you to **Discussions I've started**, **Discussions I've joined**, or **Discussions I'm following**. Within these group discussions, you can create original **Comments**, choose the **Like** icon (thumbs up) or **Unlike** it, or choose the pass icon (thumbs down). Some groups have a **Jobs** tab that allows you to review jobs posted by other group members or yourself. Groups help facilitate the sharing of knowledge and best practices as well as provide a place for people to come when they are looking for answers. (For more on accounting-specific groups, see "LinkedIn Tips for CPAs" in this issue, page 44.)

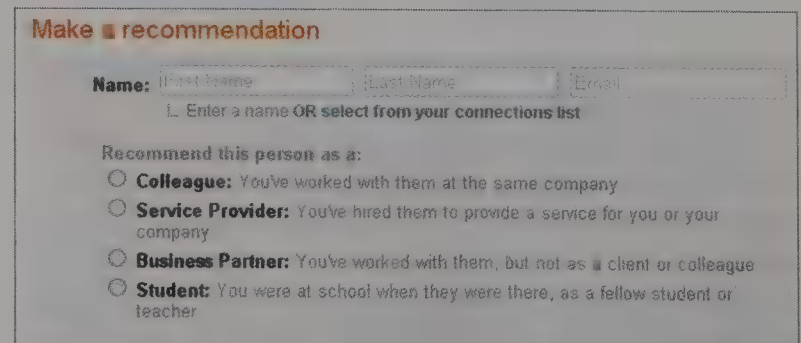
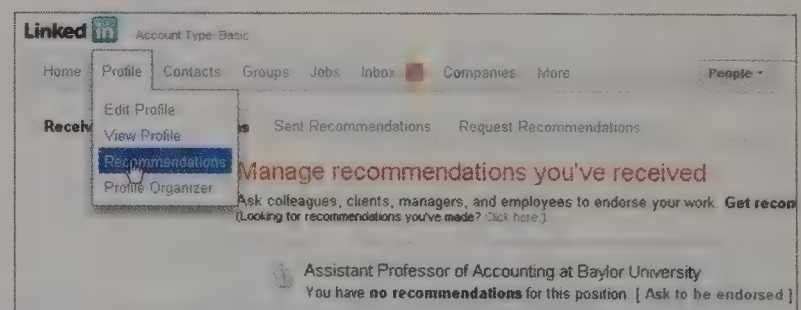
Another hotspot of activity and opportunity is the **Answers** portion of LinkedIn available in the **More** dropdown tab (see the screenshot atop the next column). The **Answers** section allows users to read past, closed Q&As or ask/answer open questions. Questions and answers are topically organized; the Finance and Accounting category contains 10 subcategories, including Auditing, Budgeting, Corporate Tax, and Mergers and Acquisitions.

Answering questions respectfully and promptly can help build your online business reputation and credibility with LinkedIn users outside your connection network.



RECOMMENDATIONS

Rather than writing "Recommendations Available Upon Request" or simply listing names at the bottom of your resume, LinkedIn allows you to post written recommendations directly to your LinkedIn profile (see the screenshots below). To request **Recommendations**, which are found in the **Profile** tab, first choose one of your positions and then specify which of your connections you want to write your recommendation; an e-mail created from within LinkedIn will send your request. You will receive your recommendation with an option to accept and post to your profile, request a replacement (due to spelling or other error), or archive (ignore). When writing recommendations for others, you may enter their e-mail address directly, locate them among your connections, or visit their profile. You will be asked to specify whether they are a colleague, service provider, business partner or student. Sent recommendations can be revised, replaced and withdrawn. The person receiving the recommendation must approve changes before they are posted on his or her profile. Withdrawn recommendations do not alert the person to whom the original recommendation was written.



WORDS OF CAUTION

Even amid the numerous benefits of LinkedIn's networking, criticisms exist. Some fear that the younger generation will grow up relying solely on impersonal, Internet relationships, potentially replacing good, old-fashioned personal conversation and hand-shaking. The use of LinkedIn for professional networking along with the many social networking sites in use may be seen as a social skills disaster. Furthermore, many LinkedIn connections are made with people you know from a pre-professional time of life. It may be that your college reputation is not the same as your current, working professional reputation. Also, even with LinkedIn's spam-control features, some members may use the site for self-promotion and send groups messages about their products or services offered.

Being smart about whom you accept as a connection is one way to help combat any potential disadvantages. Do not try to be the "hub" of all LinkedIn; it will weaken your credibility. Be honest in your profile. Use a profile picture, but ensure it is a current, professional photo. Save the casual pose, family photo or logo for a less formal social networking site. It's important to create your executive summary in a Word document first. Spelling and grammar errors can be costly. Finally, be sure to visit the **Learning Center** link located in the **More** tab. There you will find additional helpful resources and user guides. (See the re-

sources box at the end of this article.) The **Customer Service** link is particularly useful for basic keyword searches. You now have background knowledge about the creation of and the many advantages of a LinkedIn account. Ready, set, Link In! ♦

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To comment on this article or to suggest an idea for another article, contact Alexandra DeFelice, senior editor, at adefelice@aicpa.org or 212-596-6122.

AICPA RESOURCES

Webcasts

AICPA Social Media webcast archive, tinyurl.com/4nngzsg

PCPS Social Media Toolkit

This toolkit from the Private Companies Practice Section includes deep-dive guides for four tools (Twitter, LinkedIn, Facebook and blogging), instructions for developing a sample social media usage policy, overall guidance on how to figure out where to start and how social media should be a part of an integrated marketing strategy, tinyurl.com/38vrsqd



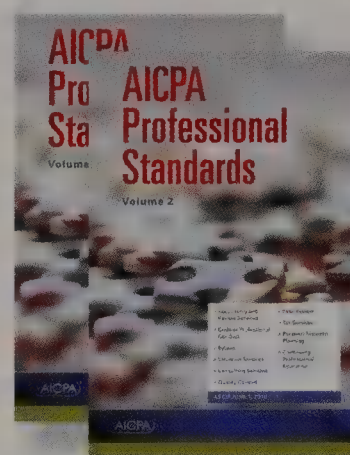
AICPA Professional Standards

AICPA Professional Standards provides a comprehensive source of professional standards applicable to non-public companies, and contains pronouncements issued by the AICPA.

This edition includes four new SASs, SSAE No. 16, SSARS No. 19, and more.

Professional Standards includes statements on:

- Auditing Standards and Related Interpretations
- Standards for Attestation Engagements and Related Interpretations
- Standards for Accounting and Review Services and Related Interpretations
- Quality Control Standards
- Standards for Valuation Services
- Standards for Tax Services and Related Interpretations
- Responsibilities in Personal Financial Planning Practice
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TAX PRACTICE CORNER

Motor Fuel Tax Refund for Off-Road Use

Many taxpayers may be overlooking the refund or credit available under IRC § 6421 for federal excise taxes paid for motor fuels and similar state provisions. The taxes are on fuels used to power vehicles and equipment on roads and highways. Taxes paid for fuel to power vehicles and equipment used off-road may qualify for the refund or credit. This includes farm equipment and certain boats, trains and airplanes.

In most states and for the federal government, the taxes collected are placed into a special fund designated for highway and road construction and maintenance. The federal trust fund is primarily devoted to the interstate highway system and related infrastructure maintenance and improvement. Each state administers its own highway trust fund. For federal purposes, the credit applies only to business use of fuel. With some exceptions, states with specific laws and procedures for a refund or credit for off-road fuel use generally do not require that use to be for business purposes. A number of states, however, do not allow refunds for fuels used in recreational vehicles or recreational use of motor boats. Some set a threshold number of gallons purchased and used during a year or other period for claiming a refund.

For large farming, fishing or other fuel-intensive businesses, the amount of the refund can be significant. In 2010, the federal tax per gallon generally was 18.3 cents for gasoline and 24.3 cents for diesel fuel. Diesel fuel is also available for off-road use without payment of excise tax, in which case it is dyed to designate it as exempt. Taxpayers that produce their own fuel, such as biodiesel, are required to file and pay for any over-the-road usage of the fuel.

In 2010, the federal tax per gallon generally was 18.3 cents for gasoline and 24.3 cents for diesel fuel.

To claim a credit for the federal tax, taxpayers file with their tax return Form 4136, *Credit for Federal Tax Paid on Fuels*. If the expense for purchasing the fuel (including the tax) is deducted as a business expense, the credit or refund must be included in gross income by the taxpayer.

Taxpayers with at least \$750 in credit or refund due in a quarter or any number of quarters within a year may file for a refund with Schedule 1 of Form 8849, *Claim for Refund of Excise Taxes*.

Taxpayer records should include the name and address of the seller of the fuel, dates of purchase and number of gallons purchased during the year for each type of qualified business use. Under Treas. Reg. § 48.6421-4(b), qualified business use of gasoline includes gasoline used in stationary engines for certain equipment, such as compressors and generators. Furthermore, for a highway vehicle, not only must the use be off a road or highway, but also the vehicle must not be registered or required to be registered for highway use under the laws of any state or foreign country (IRC § 6421(e)(2)(A)). A credit was denied a trucking company for fuel consumed while its trucks idled at rest stops beside the highway, even though on-board computers recorded the amount of fuel so used (*Hi-Way Dispatch Inc. v. U.S.*, 858 F. Supp. 880 (1994)). Only fishing or whaling are considered qualifying business uses of a motorboat (section 6421(e)(2)(B)).

A refund is also available under sections 6421(b) and (c) to private operators of school buses and buses for public transport and certain other exempt purposes described in section 4221.

STATE REFUNDS

The state taxes per gallon of motor fuel vary from 8 cents in Alaska to 37.5 cents in Washington. For diesel fuel, the state tax rates vary from 8 cents in Alaska to 39.6 cents in Connecticut. Each state has its own forms and rules for applying for a state motor fuel tax refund. For example, in

North Carolina, a taxpayer must keep track of fuel purchased for approved uses and report the number of gallons used on the appropriate tax form, such as Form GAS

1201, *Motor Fuel Claim for Refund Tax-Paid Motor Fuel Used Off-Highway*. The taxpayer must also report the type of equipment using the fuel, type of fuel used in each vehicle and fuel tank capacity. For farms, the taxpayer also must report the number of acres farmed.

Taxpayers that own watercraft often overlook the fact that some states refund at least some of the taxes paid on motor

fuel used to operate them. The American Boating Association has links to several states to assist in claiming the refund (americanboating.org/fueltax.asp). A separate claim is required for each state of purchase.

EXAMPLE: OFF-ROAD USE BY A BUSINESS

ABC Quarries operates gasoline-powered rock drills, crushers, generators and other equipment and six diesel-powered front-end loaders in its limestone quarries in Texas. During 2010, ABC purchased and used in the equipment 8,000 gallons of gasoline for which excise taxes were included and 9,000 gallons of undyed diesel. On its 2010 federal income tax return, ABC claims the following federal credit or refund for off-highway business use:

Fuel	Gallons	Credit per gallon	Amount
Gasoline	8,000	\$0.183	\$1,464
Diesel	9,000	\$0.243	\$2,187
Total federal refund/credit			\$3,651

ABC also calculates a Texas state refund (Form 06-106, *Texas Claim for Refund of Gasoline or Diesel Fuel Taxes*):

Fuel	Gallons	Credit per gallon*	Amount
Gasoline	8,000	\$0.20	\$1,600
Diesel	9,000	\$0.20	\$1,800
Total Texas state refund			\$3,400

* Rates are per Tex. Tax Code Ann. §§ 162.102 and 162.202.

Total federal and state refund/credit	\$7,051
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ABC reports the refund or credit in gross income on its federal income tax return. Applying a marginal corporate income tax rate of 35% makes the after-tax value of the refund or credit \$4,583, less any similar effect on ABC's Texas corporation franchise tax liability.

By **Marc I. Lebow**, CPA, Ph.D., (marc.lebow@hamptonu.edu) and **Michael McLain**, CPA, DBA, (mcklaipm@gmail.com) both of Hampton University.

To comment on this article or to suggest an idea for another article, contact Paul Bonner, senior editor, at pbonner@aicpa.org or 919-402-4434.

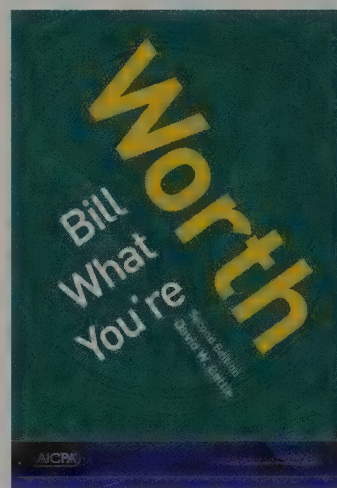


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PREPARER REGULATION

CPA-SUPERVISED NONSIGNING PREPARERS EXEMPTED FROM EXAM, CONTINUING EDUCATION

The IRS issued guidance on new regulations governing tax return preparers (Notice 2011-6), and provided an exception to its return preparer regulation plan for nonsigning preparers supervised by a CPA, attorney, enrolled agent or other Circular 230 practitioner. The notice also provides an exception for individuals who prepare returns that are not covered by the IRS' planned competency exams.

As part of the new regime, Treas. Reg. § 1.6109-2(d) provides that beginning Jan. 1, 2011, a tax return preparer must be a CPA, attorney, enrolled agent, or "registered tax return preparer" to obtain a preparer tax identification number (PTIN), which is required for all preparers who for compensation prepare all or substantially all of a tax return. "Registered tax return preparer" is a new category comprising return preparers who have met the IRS' competency testing and continuing education requirements, or will, once those are developed.

Supervised nonsigning preparers. In Notice 2011-6, the IRS carved out an AICPA-advocated exception from the competency examination and continuing education requirements allowing nonsigning preparers who are 18 or older and for compensation prepare, or assist in the preparation of, all or substantially all of a tax return or claim for refund to obtain a PTIN if:

- The individual is supervised by a Circular 230 practitioner (that is, an attorney, CPA, enrolled agent, enrolled retirement plan agent, or enrolled actuary authorized to practice before the IRS);

- The supervising Circular 230 practitioner signs the tax returns or claims for refund prepared by the individual;

- The individual is employed at the law firm, CPA firm or other recognized firm of the tax return preparer who signs the tax return or claim for refund; and

- The individual passes the IRS-required tax compliance check and suitability check (when available).

The notice provides definitions of "law firm," "CPA firm," and "recognized firm" for purposes of the exception. A CPA firm is "a partnership, professional corporation, sole proprietorship, or any other association that is registered, permitted, or licensed to practice as a certified public accounting firm in any state, territory, or possession of the United States, including a Commonwealth, or the District of Columbia." A "recognized firm" is any similar entity other than a law firm or CPA firm that "has one or more employees lawfully engaged in practice before the IRS and that is 80 percent or a greater percent owned by one or more" Circular 230 practitioners.

Individuals who receive PTINs under this exception will not be required to meet the competency examination or continuing education requirements that will be imposed on registered tax return preparers. However, such individuals must not sign any tax returns that they prepare or assist in preparing for compensation. They cannot represent taxpayers before the IRS, and they cannot claim to be either a registered tax return preparer or a Circular 230 practitioner.

The IRS warns that nonsigning preparers who qualify under this exception are subject to the duties and restrictions in subpart B of Circular 230, even though they are not Circular 230 practitioners.

Preparers of returns not covered by

competency exam. At least initially, the IRS will test preparers only on Form 1040 returns. Notice 2011-6 provides that individuals may obtain a PTIN without passing the competency examination if they certify that they do not prepare or assist in preparing the Form 1040 series (or other returns covered by future examinations) and they pass the required tax compliance check and suitability check (when available). These individuals will also be excused from the continuing education requirements, although the IRS says that it may require them to meet those requirements in the future.

Forms that do not require a PTIN. The regulations specify that the PTIN requirement applies to any return, claim for refund or tax form submitted to the IRS unless specifically excluded. The notice listed 28 forms or series of forms not subject to the PTIN requirement. They include some common information reporting forms, such as Forms W-2 and W-7 and the Form 1099 and 1098 series, as well as several types of applications and requests.

INCOME VS. CAPITAL CONTRIBUTION

STATE PAYOUT BONUSES WERE CAPITAL CONTRIBUTIONS

The U.S. District Court for the Middle District of Florida held that payments received by an insurance company from the state of Florida were capital contributions and not income, since the state intended the payments to be nonshareholder capital contributions to encourage capital investment by private insurers in the Florida insurance market.

IRC § 118(a) excludes "any contribution to the capital of the taxpayer" from gross income. Treas. Reg. § 1.118-1 permits

the exclusion of capital contributions of shareholders and nonshareholders from income, including contributions of money or property by a government, if used as an inducement to relocate or expand the recipient's business. However, if the payments are received in return for services provided or to limit production, they are included in income.

The Supreme Court in *U.S. v. Chicago, Burlington & Quincy Railroad Co.*, 412 U.S. 401 (1973), stated that the intent or motive of the nonshareholder transferor determines whether there is a capital contribution and listed five characteristics of a nonshareholder capital contribution. The payment must become part of the recipient's permanent working capital, be bargained for, result in a benefit to the recipient in an amount roughly equal to the payment, and be used to produce additional income. It may not be received in return for an identifiable good or service. The Eleventh Circuit Court of Appeals, in *U.S. v. Coastal Utilities Inc.*, 514 F.3d 1184 (2008), added that other characteristics may be examined if they are helpful to determine intent.

Southern Family Insurance Co. was formed in 1996 to take advantage of a program established by Florida after the number of private insurers writing windstorm policies in the state drastically decreased after Hurricane Andrew in 1992. The Florida Legislature created the Residential Property and Casualty Joint Underwriting Association (JUA) to be the insurer of last resort for windstorm policies; however, by 1996 the JUA had almost a million policies in force. To encourage private insurers to write more windstorm policies, new legislation provided takeout bonuses of up to \$100 per policy transferred from the JUA to private insurers. The bonuses were put into an escrow account, and if the private insurer provided coverage for three years and complied with other provisions of the law, the insurer would receive the bonuses. For policies written by Southern Family, the JUA deposited into escrow \$7,125,000 for 1996; \$4,754,281 for 1997; \$2,430,458

for 1998; and \$832,100 for 1999.

The latter year's amount was released at the end of the escrow period to the company, which reported it on its corporate tax return as a nontaxable capital contribution. The IRS determined the bonuses for 1996–99 should have been included in Southern Family's income in the same year the JUA deposited the money into the escrow accounts. Southern Family paid the taxes and filed suit in District Court for a refund of those taxes. In July 2010, the court held that the amounts should not be income when deposited into the escrow account; however, that holding would matter only if the court later ruled that the amounts were income (included in income in the year of release), not capital contributions.

In December 2010, the court held that the payments were capital contributions and thus excludable from income. It held that the language of Florida's legislation intended that the bonuses would be paid-in capital, not income. After apply-

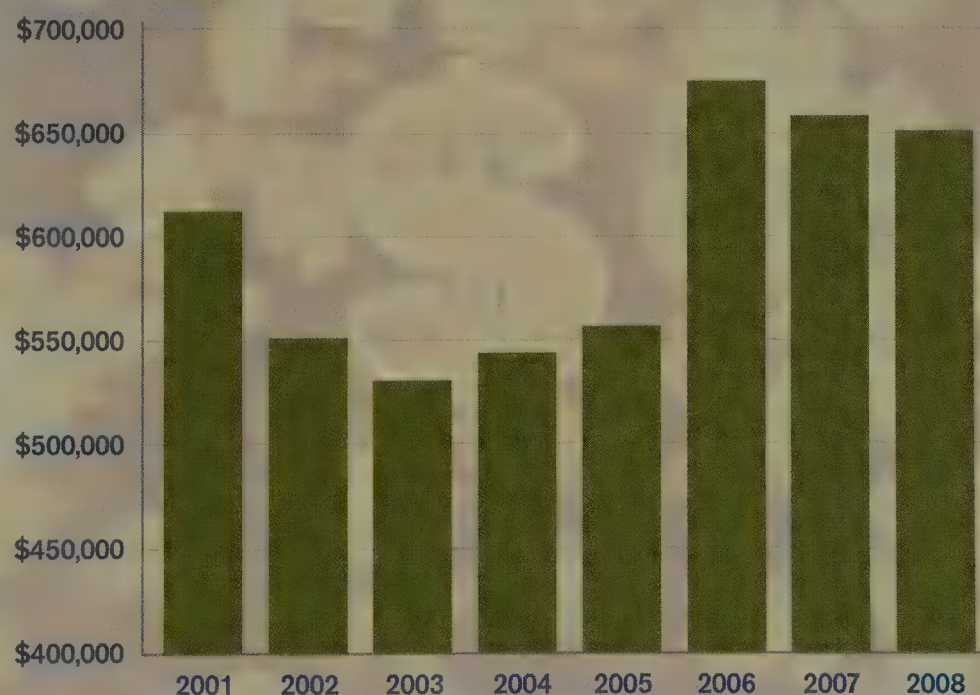
ing the five factors of *Chicago, Burlington & Quincy Railroad Co.*, the court held that the bonuses became part of Southern Family's permanent capital. The bonuses were bargained for, since the two parties negotiated the takeout arrangements. Also, the bonuses were paid in cash, causing the benefit received by Southern Family to correspond to the value of the bonuses. Also, those bonuses helped Southern Family write more policies, which produced additional income. The court also held that any services provided by Southern Family were to its policyholders, not to the JUA. The JUA received no direct benefit from those payments, and the sole purpose of the payments was to benefit the private insurance market in Florida.

■ *Southern Family Insurance v. U.S.*, docket no. 8:05-cv-2158-T-30MAP, M.D. Fla., 12/1/2010

By **Charles J. Reichert**, CPA, professor of accounting, University of Wisconsin–Superior. ➤

Average Credit for Increasing Research Activities

Returns of active corporations other than on Forms 1120S, 1120-REIT and 1120-RIC.



Source: Figure A, Annual Percentage Changes, "Corporation Research Credit," IRS Statistics of Income, tinyurl.com/3y39opa.

INNOCENT SPOUSE RELIEF

EDUCATED SPOUSE DENIED RELIEF

The Tax Court upheld the IRS position that an educated spouse was unreasonable in believing her ex-husband would pay a tax deficiency, and denied her innocent spouse relief.

Elizabeth B. Kelly, who had received a degree in social science, married Sean Kelly in 1981. Sean Kelly worked at Portfolio Analytics, a brokerage and investment services company, as a marketing consultant. In 1987 Elizabeth Kelly also began working at Portfolio Analytics. Although as office administrator her position was less prominent than her husband's, she had an ownership interest in the company. Sean Kelly's father operated a retirement plan consulting company he had founded. In 1997 Sean Kelly and his parents formed EPC Consulting, to provide services to early retirement plans of teachers on the West Coast.

Sean and Elizabeth Kelly's lifestyle featured several cars, private school tuition

for their children, ownership of a horse, and a \$900,000 home. Elizabeth Kelly managed the household and paid all the bills. She also worked with their accountant when having their joint income tax returns prepared.

Sean Kelly developed alcohol and drug addiction problems and ran up extravagant expenses charged to EPC Consulting. As a result, his parents bought out his share of the business as part of a severance agreement. The Kellys ultimately had difficulty paying their bills and developed bad credit as a result of reduced income and their continued high lifestyle. In 2009 they were divorced.

In 2004 and 2005, the Kellys reported total income of about \$446,000 and \$505,000, respectively. Those amounts included about \$357,000 and \$321,000, respectively, from severance payments from EPC Consulting to Sean Kelly. For the years in question there was little tax withholding or estimated taxes paid, and none of the severance money was used to pay the taxes. The unpaid tax liabilities were nearly \$100,000 for 2004 and \$115,000 for 2005. Elizabeth Kelly

signed the tax returns each year, subsequently contending to the IRS that she did so because her husband had agreed to pay the balances due.

In 2006 the IRS began collection activities, and neither of the Kellys requested a collection due process hearing. In 2008 Elizabeth Kelly filed Form 8857 requesting innocent spouse relief under IRC § 6015, which the IRS denied, since she had missed the two-year deadline for filing as required in sections 6015(b) and (c). She then petitioned the Tax Court seeking equitable relief under section 6015(f). Although the statute does not specify a two-year deadline for filing under subsection (f), the IRS has imposed one in Treas. Reg. § 1.6015-5(b)(1). The Tax Court has held the regulation invalid but has been reversed by the Seventh and Third circuits (see "Innocent Spouse Relief: Alternatives After the Lantz Case," *JofA*, Dec. 2010, page 46, and "Line Items: Another Circuit Upholds Two-Year Limit for Innocent Spouse Claims," below). However, the Tax Court did not address the timeliness issue in the instant case, deciding it on

Selected Sources of AGI*, 2007–2008

	Amount (millions)		Percentage Change
	2007	2008	
Sales of property other than capital assets, net gain (less loss)	\$4,357	-\$7,811	-279.3%
Net capital gain (less loss)	\$907,656	\$469,273	-48.3%
Taxable interest	\$268,058	\$223,291	-16.7%
Partnership and S corporation net income (less loss)	\$414,705	\$366,965	-11.5%
<hr/>			
Taxable individual retirement account distributions	\$147,959	\$162,150	9.6%
Unemployment compensation	\$29,415	\$43,675	48.5%
Rental and royalty net income (less loss)	\$20,639	\$32,940	59.6%
<hr/>			
*Adjusted gross income	\$8,687,719	\$8,262,860	-4.9%

Source: IRS, Statistics of Income Bulletin, Fall 2010, "Individual Income Tax Returns, 2008," Figure B, tinyurl.com/3aa3v95.

other grounds.

The Tax Court considered the safe harbor provisions of Revenue Procedure 2003-61. A spouse requesting relief must have no knowledge or reason to know that the other spouse would not pay the tax. The court found that Kelly should have known that her husband would not pay the tax. The court noted that she had taken responsibility for paying the household's other bills, her husband had a drug and alcohol addiction, he exhibited erratic behavior, and his severance pay had not been set aside or used to pay the tax at the time of filing. She knew of the family's financial problems, and she was "an educated person" with more than 20 years of experience in the financial industry. The court was not sympathetic on the issue of economic hardship after considering conflicting information supplied to the IRS and seeing monthly expenses that included more than \$300 for satellite television, more than \$250 for cell phones, and more than \$150 for maintenance of a horse.

In considering equitable factors under section 4.03 of the revenue procedure, the court still found no reason to grant innocent spouse relief. Although the tax liability was substantially her husband's, and he had agreed to pay it under the terms of the divorce agreement, she should have known he could not pay. The court said Elizabeth Kelly received a significant benefit from the unpaid tax liability, specifically, her high lifestyle. Because of Elizabeth Kelly's level of education and her involvement with the accountant preparing the tax returns, the court rejected her claim that she did not know she could file separately.

■ *Elizabeth B. Kelly v. Commissioner*, TC Memo 2010-267

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Line Items

DEFYING COURTS, IRS FINALIZES BASIS OVERSTATEMENT RULES

The IRS released final regulations defining an omission from gross income for purposes of the extended six-year limitations period for assessment of tax (TD 9511). The regulations finalize without change temporary regulations (TD 9466) that the Tax Court held to be invalid last May (*Intermountain Ins. Serv. of Vail LLC*, 134 TC no. 11 (2010); see previous Tax Matters coverage, Aug. 2010, page 67, and Nov. 2009, page 70). In its decision, the Tax Court followed the Ninth and Federal circuits (*Bakersfield Energy Partners*, 568 F.3d 767 (9th Cir. 2009), and *Salman Ranch Ltd.*, 573 F.3d 1362 (Fed. Cir. 2009)) in applying the Supreme Court's holding in *Colony v. U.S.*, 357 U.S. 28 (1958), that an overstatement of basis and resulting understatement of gain does not constitute an omission from gross income for purposes of IRC §§ 6229 and 6501.

However, the Seventh Circuit Court of Appeals on Jan. 26 reversed the Tax Court, holding the six-year period applied to a basis overstatement in a Son-of-BOSS case, *Kenneth and Susan Beard v. Commissioner* (docket no. 09-3741). For the Tax Court proceedings see TC Memo 2009-184, discussed (with *Intermountain*) in Tax Matters, Nov. 2009, page 70. Without analyzing deference to the regulations, the Seventh Circuit said *Colony* did not control outside a trade or business setting and interpreted the statutes as including overstated basis.

Section 6501(e)(1)(A) provides that if a taxpayer omits from gross income an amount that should be included and that exceeds 25% of the amount of gross income stated in the return, the period of time for assessment is extended to six years. Section 6229(c)(2) applies a similar rule to partnerships. Under Treas. Reg. § 1.61-6(a), gross income includes

"gains derived from dealings in property," and these gains are "the excess of the amount realized over the unrecovered cost or other basis for the property sold or exchanged." The final regulations provide that, outside the trade or business context, "an understated amount of gross income resulting from an overstatement of unrecovered cost or other basis constitutes an omission from gross income" for purposes of sections 6229(c)(2) and 6501(e)(1)(A) (Treas. Reg. §§ 301.6229(c)(2)-1(a)(1)(iii) and 301.6501(e)-1(a)(1)(iii)).

The IRS disagrees with the court decisions and asserted in the preamble to the temporary regulations that its position in the regulations was entitled to deference. (The Service also has appealed the Tax Court's holding in *Intermountain Ins. Serv. of Vail* to the District of Columbia Circuit Court of Appeals; oral arguments have been scheduled for April.)

The final regulations were effective Dec. 14, 2010, and for income tax purposes (the regulations also apply to estate and gift and excise taxes) will apply to tax years for which the period for assessing tax was open on or after Sept. 24, 2009 (the date the temporary regulations were issued).

MORE GUIDANCE ISSUED ON HEALTH INSURANCE CREDIT

The IRS released a new form and guidance relating to the small business health care tax credit for the 2010 tax year. The guidance (Notice 2010-82) discusses issues relating to employers' eligibility for the credit and other eligibility issues.

The notice supplements earlier guidance (Notice 2010-44; for prior Tax Matters coverage, see "Line Items: Health Care Business Credit Explained," July 2010, page 53) on the credit under IRC § 45R, added by the Patient Protection and Affordable Care Act, PL 111-148.

Beginning in years after 2009, section 45R provides tax credits for small

businesses designed to increase levels of health insurance coverage. For 2010–2013 calendar years, businesses with 25 or fewer employees and average annual wages of less than \$50,000 are eligible for credits of up to 35% of nonelective contributions on behalf of employees for insurance premiums. Charitable tax-exempt organizations under section 501(c) get a 25% credit against payroll taxes. (For years after 2013, the amounts of the credit are 50%, and 35% for exempt organizations.) The amount of the credit is based on a percentage of the lesser of: (1) the amount of nonelective contributions paid by the eligible small employer on behalf of employees under the

employees for purposes of the credit. However, the section 45R definition of “family member” does not specifically refer to spouses. The IRS says, however, that certain spouses are nevertheless excluded from the definition of employee:

- The employee-spouse of a shareholder owning more than 2% of the stock of an S corporation;
- The employee-spouse of an owner of more than 5% of a business;
- The employee-spouse of a partner owning more than a 5% interest in a partnership; and
- The employee-spouse of a sole proprietor.

issued in November 2010, supplements a chief counsel notice (CC-2010-018), in which the IRS said it would no longer challenge or litigate whether interchange fee income from credit card transactions creates or increases original issue discount (OID) on a pool of credit card loans. But in the latest directive, the IRS said it would continue to develop remaining open issues, including:

- Whether an issuing bank has properly calculated accrual of credit card fees treated as OID for purposes of IRC § 1272(a)(6) (daily accrual of OID where payment of principal is subject to acceleration by prepayment of other obligations securing the debt, or for other reasons); and

- Whether an issuing bank has properly changed its accounting method with respect to the treatment of credit card fees as OID subject to deferral under section 1272(a)(6).

The directive reverses LMSB-04-0208-002, April 22, 2008, which stated that interchange and merchant discount fees (designated a Tier II issue) are not interest and cannot constitute OID subject to deferral. In the *Capital One* case, the Tax Court held that the fees, which are paid by merchants to a credit card's issuer for customer transactions using the card, could be recognized as OID over the life of a credit card obligation. The court rejected the IRS' position that the fees collected by Capital One were payment for services (see “Tax Matters: Credit Card Fees Are OID,” *JofA*, Jan. 2010, page 58).

ANOTHER CIRCUIT UPHOLDS TWO-YEAR LIMIT FOR INNOCENT SPOUSE CLAIMS

The Third Circuit Court of Appeals joined the Seventh Circuit in upholding the IRS' two-year limit for filing a claim for innocent spouse equitable relief under IRC § 6015(f). The Third Circuit reversed a holding by the Tax Court that taxpayer Denise Mannella timely petitioned the IRS for innocent spouse equitable relief from unpaid taxes, penalties and interest arising from returns filed jointly with her husband. She filed the petition more than 28 months after

Beginning in years after 2009, section 45R provides tax credits for small businesses designed to increase levels of health insurance coverage.

arrangement during the tax year and (2) the amount of nonelective contributions the employer would have paid under the arrangement if each such employee were enrolled in a plan that had a premium equal to the average premium for the small group market in the state (or in an area in the state) in which the employer is offering health insurance coverage. For taxable entities, the credit is part of the general business credit; for tax-exempt entities, it is allowed as a refundable credit limited by the sum of income tax withheld from all employees' wages during the year, plus employer and employee amounts for Medicare tax.

The notice also states that eligible small employers outside the United States that have income effectively connected with the conduct of a trade or business in the U.S. may claim the credit only if the employer pays premiums for health insurance coverage issued in and regulated by one of the 50 states or the District of Columbia.

Under section 45R, sole proprietors, partners in a partnership, shareholders owning more than 2% of the stock in an S corporation, and any owners of more than 5% of other businesses—and their family members—are not taken into account as

The notice says that leased employees are counted in computing a small business's full-time-equivalent employees for purposes of the credit; however, the business cannot take into account premiums paid by the leasing organization on behalf of a leased employee. The notice also clarifies that health savings accounts and self-insured plans, including health reimbursement arrangements and flexible spending arrangements, are not “qualifying arrangements” for purposes of the credit because they are not health insurance coverage. The notice also discusses multiemployer health and welfare plans and church welfare benefit plans, which can count as qualifying arrangements for the credit.

IRS ACQUIESCES TO CAPITAL ONE; FEE STILL SCRUTINIZED

Although it will not challenge a position upheld by the Tax Court (*Capital One Financial Corp. and Subsidiaries v. Commissioner*, 133 TC 136) allowing deferral of income recognition from credit card interchange fees, the IRS will continue to address related issues, the Service said in a Large Business & Industry division directive (LB&I-4-1110-030). The directive,

the IRS began collection procedures with a notice of intent to levy. In so holding, the Tax Court had ruled invalid regulations requiring petitions under section 6015(f) to be filed within two years after the IRS begins collection actions (see prior coverage in "Tax Matters," July 2009, page 76, and Sept.

837 (1984))—that is, that the statute is ambiguous, but the regulation does not clearly violate congressional intent. Although the court thus ruled Mannella's innocent spouse request untimely, it remanded to the Tax Court for further consideration her claim for equitable tolling of the deadline period.

The Third Circuit ruled that the statute is ambiguous, but the regulation does not clearly violate congressional intent.

2010, page 68). Earlier, the Tax Court had reached a similar conclusion in *Cathy Marie Lantz v. Commissioner*, 132 TC 131, which the Seventh Circuit reversed and remanded last June (607 F.3d 479).

The Third Circuit applied the reasoning of *Lantz* and the *Chevron* standard of deference to the regulation (*Chevron v. Natural Resources Defense Council Inc.*, 467 U.S.

Mannella contended that her husband signed her name to the postal return receipt for the notice of intent to levy and did not tell her about it until more than two years later.

CO₂ RULED A FOOD

The Streamlined Sales Tax Governing Board last fall approved a request that

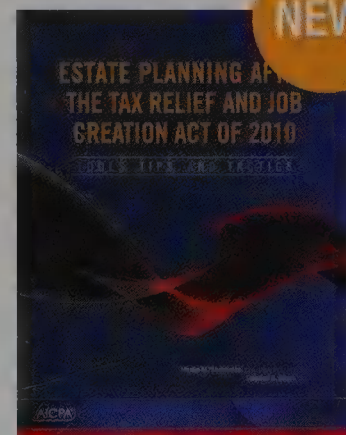
"food or food ingredient," as used in the Streamlined Sales and Use Tax Agreement (SSUTA), be interpreted to include carbon dioxide used as part of a "tabletop seltzer-making kit." The status of the beverage-grade CO₂ for sales and use tax purposes had been unclear, since the SSUTA defines "food or food ingredients" as "[s]ubstances, whether in liquid, concentrated, solid, frozen, dried, or dehydrated form, that are sold for ingestion or chewing by humans and are consumed for their taste or nutritional value," but does not specifically mention gases. A Chicago attorney requested the interpretation on behalf of a client company that distributes and refills the carbon dioxide canisters used in the units. The request argued that the resulting fizz met the part of the definition relating to consumption of a food item for its taste, since it "changes the taste (and texture) of the water and makes for a pleasant drinking experience." ♦



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TIMELY REFUND CLAIMS

When Is a Supplemental Claim a New Claim?

For taxpayers, timeliness is crucial for certain acts, such as filing a refund claim with the IRS within the statute of limitation period. A refund claim must set forth in detail each ground upon which a credit or a refund is claimed and include facts sufficient to apprise the IRS of the exact basis for it. Occasionally, a taxpayer may want to amend a previously filed refund claim after the refund limitation period. Certain factors dictate whether this supplemental claim—also referred to as a revised supplemental claim—is deemed to be an amendment to an existing claim, which may be allowed because it is based on the grounds established in a previously timely filed claim, or a new claim, which may be disallowed because it is after the period allotted for filing a refund claim for such items.

AMENDMENT OR NEW CLAIM?

Courts have generally established a two-part test for determining whether a supplemental claim is an amendment of an existing claim or a new claim. A supplemental claim is deemed to be an amendment to a properly filed refund claim (and permitted after the expiration of the statute of limitation period for filing the refund claim) if:

- The amendment is “germane” to the original claim; and
- The amendment is presented before the original claim is resolved (*Andrews*, 302 U.S. 517 (1938)).

Some courts analyze amendments to claims under two distinct doctrines: the general claim doctrine and the germaneness doctrine. The general claim doctrine may apply where (1) the taxpayer has filed a formal general claim within the limitation period and (2) an amendment is filed outside the limitation period that makes the general claim more specific. The germaneness doctrine may apply where (1) the taxpayer files a formal claim within the limitation period, making a specific claim, and (2) after the limitation period, but while the IRS still has jurisdiction over the claim, the taxpayer files a formal amendment raising a new legal theory (not specifically raised in the original claim) that is germane to the original

claim. See *Computervision Corp.*, 445 F.3d 1355 (Fed. Cir. 2006).

SUMMARY

Taxpayers often want or need to supplement previously filed claims. They may discover errors that need correction, or discover opportunities for additional refunds. It is important, however, for taxpayers and their tax advisers to be mindful of the statute of limitation when filing supplemental claims because timing can affect the acceptability of the claim. If an amendment to a properly filed refund claim is filed after the IRC § 6511(a) statute of limitation period, it needs to be germane to the original claim and be presented before the original claim is resolved for the IRS to consider it timely.

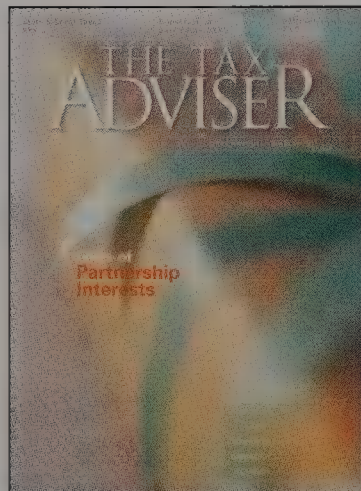
For a detailed discussion of the issues in this area, see “Supplemental Claims: Acceptable Amendment or New Claim?” by John Keenan, Esq.; Rona Hummel, CPA; and Whitney Lessman, Esq., in the March 2011 issue of *The Tax Adviser*.

—Alistair M. Nevius, editor-in-chief
The Tax Adviser

Also look for articles on the following subjects in the March 2011 issue of *The Tax Adviser*:

- An update of state and local corporate tax developments.
- A discussion of gifts of partnership interests.
- An analysis of the conservation easement rules.

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	AICPA Member \$135.00	AICPA Member \$469.00	AICPA Member \$969.00	AICPA Member \$1,369.00	AICPA Member \$799.00	AICPA Member \$1,299.00	AICPA Member \$1,699.00
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Technology Q&A

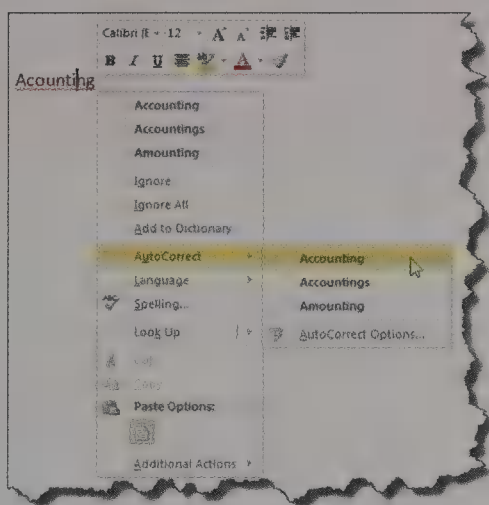
by J. Carlton Collins

I stand corrected...I don't want to lose you...Your cheating chart...The blind side of e-mail...
The search for a better search...Five Excel quick tips

I STAND CORRECTED

Q Sometimes when I misspell a word, Word automatically corrects the spelling for me, but other times it doesn't. Does this indicate a problem with my spell checker settings?

A Office 2003, 2007 and 2010 include a feature called **AutoCorrect** that is useful in two ways, as follows: As you misspell words in Word, you can right-click on them to display an assortment of correction options. For example, when you right-click on the misspelled word "Accounting," Word will display several correction options, as shown below.

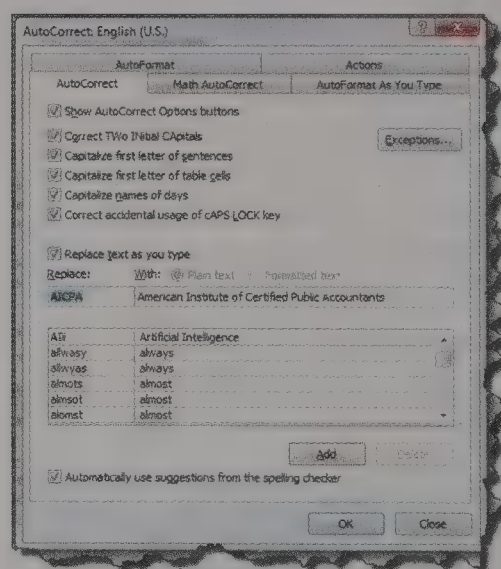


You could correct the spelling by selecting the properly spelled word at the top of the list. However, if you make the same mistake frequently, you should consider selecting the properly spelled word under **AutoCorrect** instead. Thereafter, Word will automatically correct the misspelled word when you make the same error. The automatic corrections that you create in Word will also work in Excel, but you must first close and relaunch Excel.

By default, the **AutoCorrect** tool includes many common misspelling errors. For example, if you accidentally type the misspelled word "prolbem," Office will automatically correct the spelling. (Because Office automatically corrects common misspellings, but not all misspellings, it may appear to you that the automatic spell checker only works some of the time.)

Another way to use **AutoCorrect** is to create **AutoCorrect** text for lengthy phrases that you type frequently. For example, let's assume that you regularly type the phrase "American Institute of Certified Public Accountants." You could save time by creating an **AutoCorrect** text shortcut in which you type AICPA, and Word fills in the complete phrase for you. To create an **AutoCorrect** shortcut, display the **AutoCorrect** dialog box as follows:

- In Word 2003, from the main menu select **Tools, AutoCorrect Options**.
- In Word 2007, from the Office Button select **Word Options, Proofing, AutoCorrect Options**.
- In Word 2010, from the **File** tab, select **Options, Proofing, AutoCorrect Options**.



Next, in the **Replace:** box type in an abbreviation that you will remember. In the **With:** box type in the complete phrase that the abbreviation represents, then click **Add** and **OK**. Thereafter, when you enter the abbreviation in Word, Excel or PowerPoint, the complete phrase will appear. (To delete an **AutoCorrect** entry, repeat the above steps and click the **Delete** button, instead of the **Add** button.)

Hint: If Word inserts the **AutoCorrect** phrase when you really want the abbreviation, press Ctrl+Z to undo **AutoCorrect**.

I DON'T WANT TO LOSE YOU

Q I've had two employees lose their cell phones. Each time they lost valuable client contact information. I don't want this to happen again. What is the best way to back up contact data on a cell phone?

A Backing up your cell phone data is a good idea because cell phones are prone to getting wet, damaged, lost or stolen. A good backup solution is to use your phone's built-in backup utility (which is available with most cell phone services). It is typically free, quick and easy. The specific procedures for backing up your phone contacts will differ slightly depending upon your service provider, brand and type of phone.

Not only does this procedure back up your contacts, but also it is an effective method for moving your contacts from one phone to another when you upgrade to a new cell phone.

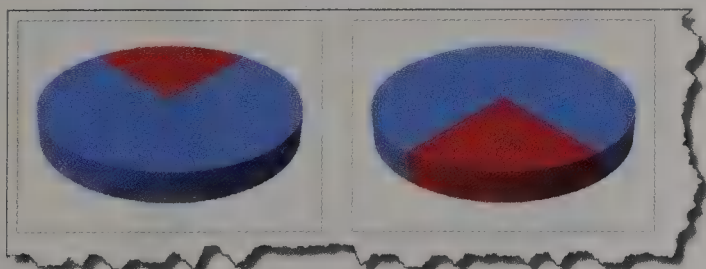
As an alternative, many cell phones offer USB data cable kits that let you synchronize your phone data to your computer. This will allow you to back up your phone's data as a separate file, or if you prefer, you can integrate and synchronize the phone's data with your contact manager application.

YOUR CHEATING CHART

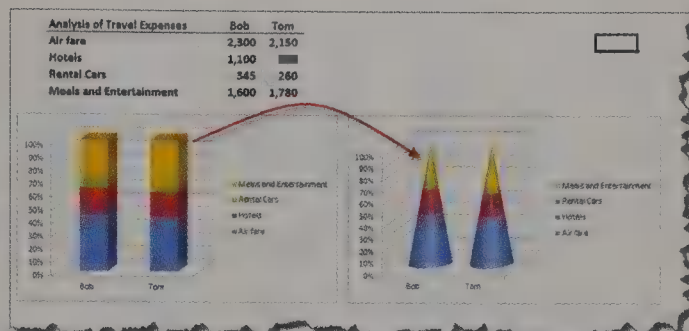
Q I find charts helpful, but I've heard that they can be used to skew data or distort actual results. Is this true, and if so, how?

A You are correct that charts are useful tools for visualizing and analyzing data. However, what you have heard is also correct—charts can sometimes be deceiving, and CPAs should be aware of this when creating or reading charts. Below are examples of charting methods that may distort data.

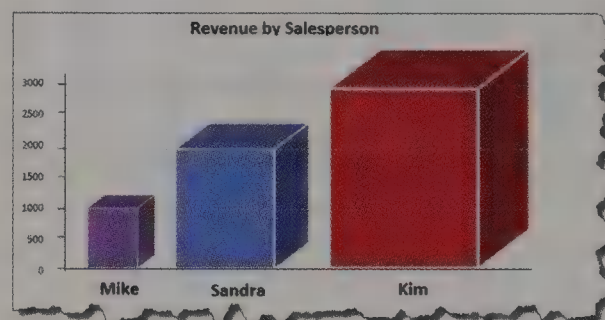
Rotating 3-D charts. The two charts shown below are identical, except for rotation. The red pie slice facing forward covers 107% more area (graphically) than the pie slice facing the rear. This technique might subliminally give the impression that the red pie slice represents a larger or smaller portion of the pie, depending upon your perspective.



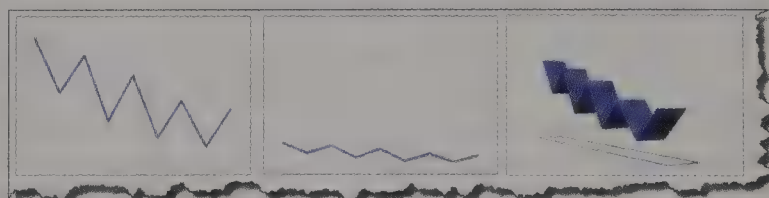
Cone charts. The two charts atop the next column are identical, except for the "cone" effect. Notice in the 3-D bar chart on the left, meals and entertainment expenses appear to represent a significant portion of the total travel expenses. However, in the cone chart on the right, meals and entertainment expenses visually appear to represent a much smaller fraction of the total travel expenses.



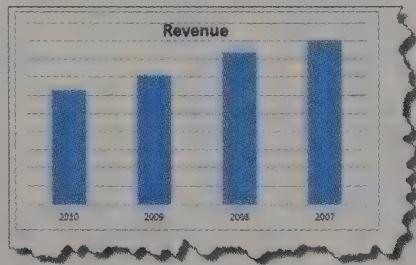
Picture charts. The chart below shows sales results for three salespersons. The chart shows that the third salesperson generated three times the amount of sales of the first salesperson (\$3,000 compared with \$1,000). Reading the chart based on data bar height, the chart reads accurately. However, because the data bars in the chart are taller and wider, the third data bar covers nine times the surface area of the first data bar, thus creating the illusion that sales were nine times higher.



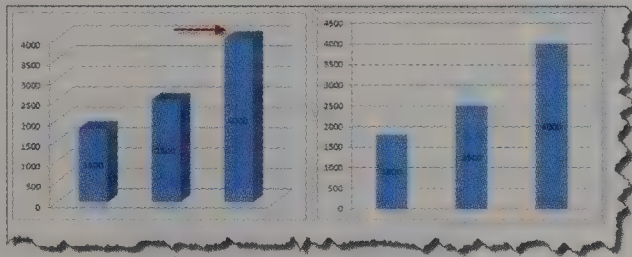
Distorted line charts using 3-D and rotation. The three charts below depict the same data. The first chart is a two-dimensional line chart, which suggests an overall downward trend in the data. The second chart is also a two-dimensional line chart, but the maximum value on the Y-axis has been increased tenfold compared to the first chart, thus flattening the line and suggesting that there is not much of a trend in the data. The third chart is a 3-D line chart, which has been rotated forward to emphasize the increase at the end of the chart. This third chart might give more of an impression that results are trending upward.



Reverse order charts. In the chart on the next page, the data are displayed chronologically from right to left. In this example, revenue has actually declined over the past three years; however, since most people read charts from left to right, they might miss the fact that the data is presented in the opposite direction. ❖



3-D bar charts. The two charts below are identical, except for the 3-D effect. Notice that in the 3-D chart, the third data bar representing 4,000 does not appear to reach the 4,000 hash mark on the Y-axis. By comparison, the same data bar displayed in a two-dimensional version of the chart does perceptibly touch the 4,000 hash mark. (The reason for this distortion is that the front of the 3-D bar lines up with the Y-axis labels on the left side of the chart, but the data bar's depth is not as great as the 3-D chart's depth.)



Armed with this information, you are in a better position to prepare and read charts without falling into distortion traps.

THE BLIND SIDE OF E-MAIL

Q If someone has sent you an e-mail and it was also sent to a blind cc, and you then hit **Reply to All**, does it also go to the blind cc or only to the individuals revealed on the e-mail?

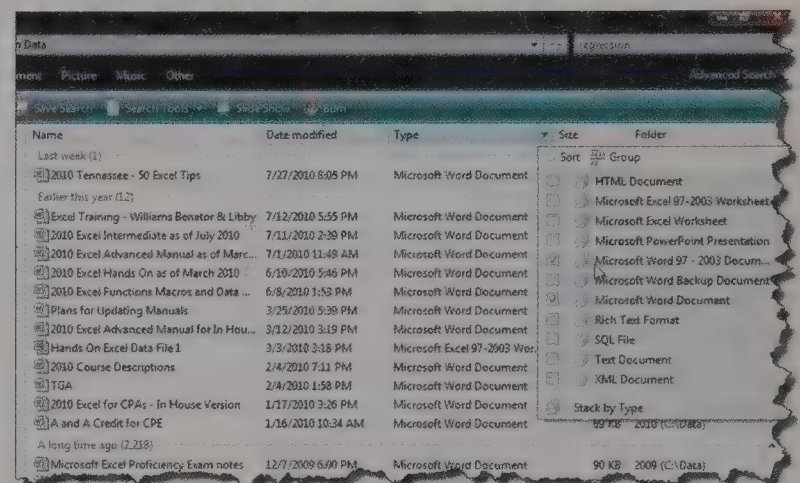
A Your concern is understandable, but no, replying to an e-mail with the **Reply to All** option does not also reply to those recipients who were blind copied on the original e-mail. By definition, when you receive an e-mail that was also blind copied to others, you have no way of knowing that other recipients were blind copied, and you certainly do not have access to their e-mail addresses.

THE SEARCH FOR A BETTER SEARCH

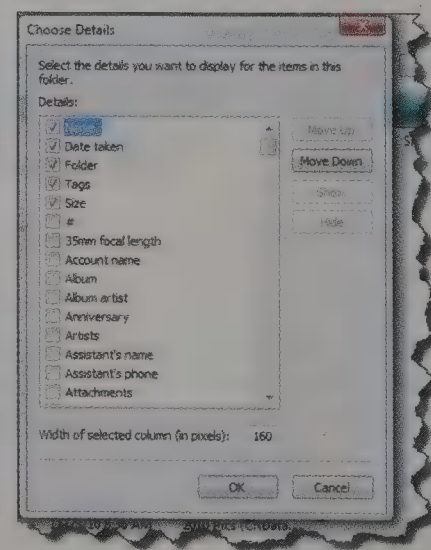
Q Our CPA firm has more than 400,000 data files on the file server, and we constantly struggle to locate the right file. For example, recently an audit staffer retrieved an Excel file that contained fixed-asset depreciation calculations and used this in the audit. Unfortunately, the version of the file retrieved was not the most current and, as a result, additional time was wasted updating the older file. We hope to avoid problems like this in the future. What is the best way to manage such a large volume of files?

A In last month's column ("Say Goodbye to Wimpy Searches," *JofA*, Feb. 2011, page 65), we addressed the concept of indexed searches, but let's dig a little deeper into this subject. The

Explorer window in Windows Vista and Windows 7 provides additional searching capabilities to help you quickly view and narrow your search results. Start by performing a search in an Explorer window. (As you may recall, last month we searched for the term "regression," and I will continue with this example.) Once Windows returns the search results for the term "regression," I can further refine my search results by clicking on any of the column headings to view filter options. For example, in the screen below I have clicked the dropdown arrow next to the **Type** column heading. This action "stacks" the data files according to "type of file." Notice that I have many file types containing the word "regression" including Excel 2003 and 2007, Word 2003 and 2007, HTML, PowerPoint, XML and others.



The search results can be narrowed by checking the boxes in the **Type** column next to the desired **Group(s)**. By default, these advanced options narrow search results by file name, date range, file type, file size and folder name. For a more refined search, Windows Vista and Windows 7 provide an additional 281 searchable field names. To access these additional field names, add them to the column headings of the **Search Results in Data** screen by right-clicking on any column-heading label and selecting **More...** to display the **Choose Details** dialog box shown below.



Place a checkmark in the box next to those field names you would like to include in the **Search Results in Data** dialog box. For example, you might add the fields **Authors**, **Comments** and **Status** to locate files authored by Albert, files containing the comment “very useful,” files containing the status “reviewed,” or files meeting all three criteria.

These additional file search methods may help your audit staff identify and select the correct fixed-asset depreciation files in the future.

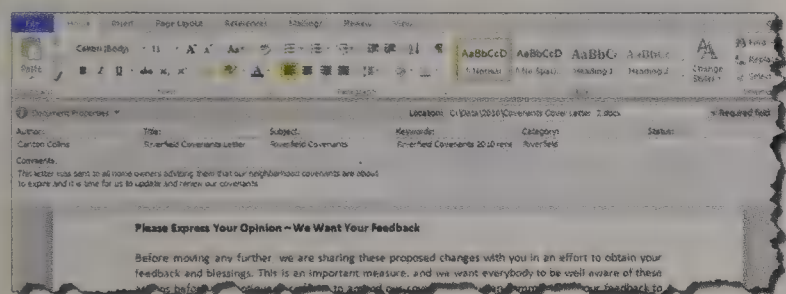
Note: The effectiveness of a search improves when document properties are added to the data files. Document properties can be added to Word documents as follows:

Word 2010: Select **File, Properties, Show Document Panel**.

Word 2007: Click on the Office Button, **Prepare, Properties**.

Word 2003: Select **File, Properties**.

The **Document Properties** panel (shown below) will allow you to insert keywords, authors, titles, comments and other custom information.



Document Properties are used by **Instant Search** to not only locate files, but also to sort the search results in priority order according to those files that most closely match your search criteria.

FIVE EXCEL QUICK TIPS

1. **Sticky format painter.** Double-clicking on the **Format Painter** icon will cause it to stick, so that you can continue to apply the desired format to multiple cells, ranges, columns or worksheets. To turn off this effect, either press the Esc key or click the **Format Painter** icon.



2. **Absolute/relative referencing.** Pressing the F4 key while in edit mode will insert absolute dollar sign references, which is an easier method than manually typing in the absolute dollar sign references. To do this, select a cell that contains a formula, and press the F2 key to enter edit mode. Within the formula, position the cursor over a cell reference and press the F4 key to insert absolute references. Before and after

examples are shown below.

Expenses	2010
Insurance	4,277 =E6/E16
Maintenance	2,394
Marketing	12,366
Miscellaneous	4,296

(**Note:** Pressing the F4 key repeatedly will toggle you through the available absolute reference options—column only; row only; both column and row; or none.)

3. **Hide zero values.** You can hide all of the zero values in a worksheet by adjusting Excel's options as follows:

- a. In Excel 2003, select **Tools, Options**. On the **View** tab, uncheck the **Zero values** box and click **OK**.
- b. In Excel 2007, select the Office Button, **Excel Options, Advanced**. Under the **Display options for this worksheet** section, uncheck the box labeled **Show a zero in cells that have zero value** and click **OK**.
- c. In Excel 2010, select **File, Options, Advanced**. Under the **Display options for this worksheet** section, uncheck the box labeled **Show a zero in cells that have zero value** and click **OK**.

4. **Display zero values as a dash.** You can display zero values in your worksheet as a dash by changing the cell's format to either the **Accounting** or **Comma Style** format.

	Jan	Feb	Mar	Apr	May	Jun
Insurance	17,108	-	25,662	-	25,662	29,939
Maintenance	11,970	7,182	7,182	14,364	7,182	11,970
Marketing	74,196	49,464	49,464	-	88,562	61,830
Miscellaneous	-	12,888	12,888	25,776	25,776	-
Office Supplies	22,047	44,094	-	22,047	25,936	58,702

5. **Black parenthesis.** When building a complex formula that contains nested functions or multiple sets of parenthesis, Excel uses colors to help you identify parenthesis pairing, and the outside parenthesis are always black. This tip can help you determine whether you have inserted the proper number of parenthesis pairs in your formula.

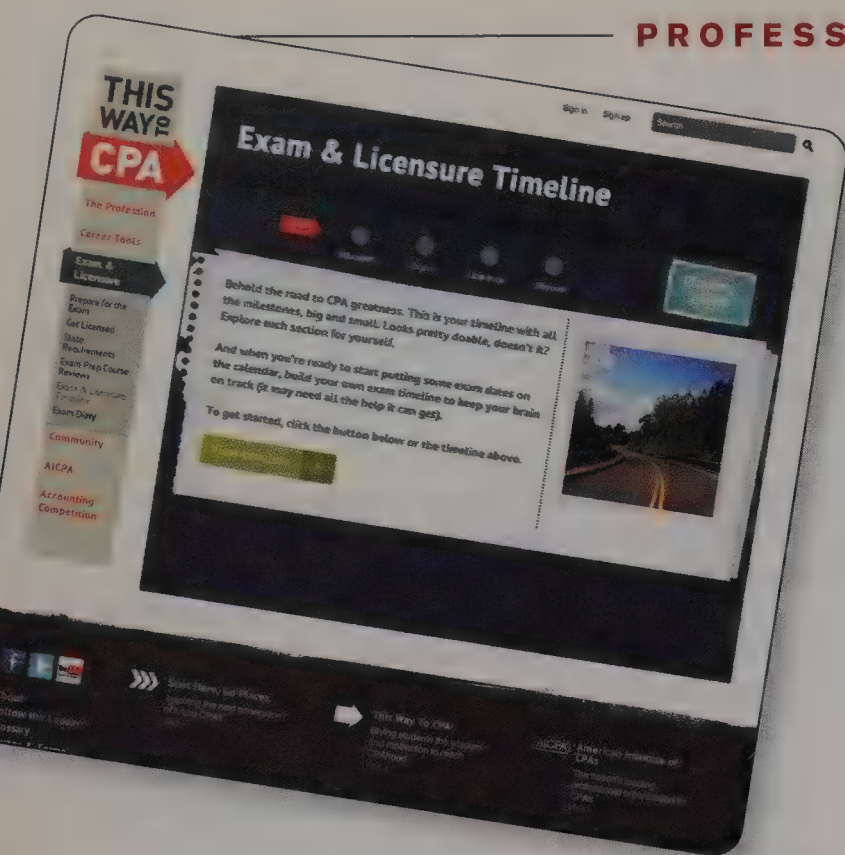
=((SUM(G24:G28)/AVERAGE(E23:E25)*1.5)/COUNT(I19:I27))

J. Carlton Collins (carlton@asaresearch.com) is a technology and accounting systems consultant and a JofA contributing editor.

Note: Instructions for Microsoft Office in "Technology Q&A" refer to the 2007 and 2010 versions, unless otherwise specified.

Submit a question

Do you have technology questions for this column? Or, after reading an answer, do you have a better solution or a tip you would like to share? Send them to jofatech@aicpa.org. We regret being unable to individually answer all submitted questions.



Institute Launches New Career Website for Future CPAs

The Institute launched a new website, *This Way To CPA*, devoted to the needs of college students interested in becoming CPAs and graduates preparing for the CPA examination.

The site, www.thiswaytocpa.com, provides career insights, career planning resources, studying strategies and social networking opportunities. It follows the AICPA's Start Here, Go Places website, which was introduced in 2001 to help high school students explore careers in accounting.

Following are some of the site's key features:

- **Tell us where you are** includes a timeline that allows visitors to select where they stand in college or in their career path, and provides them with resources pertaining to the specific stage. Timeline stages range from "Spankin' new," "Declared the major" and "Graduating soon" to "In exam land" and "Newly licensed."
- **Community** provides a forum where students and exam candidates can share their thoughts and experiences concerning the CPA exam and licensure, careers and internships, college and graduate school, and achievements and challenges. Visitors can participate in polls and discussions about topics that are top-of-mind for students and recent graduates. The community experience is further enhanced through Facebook, Twitter and a YouTube channel.
- **State Requirements** includes an interactive map with details on becoming a CPA in each of the 50 states and U.S. territories, including information on exam and state-licensure requirements: residency, number of hours of education and experience, academic degree, age and ethics. It also explains how international candidates can receive

their CPA license. In addition, students can find contact information for state CPA societies and boards of accountancy.

- **Exam & Licensure Timeline** provides a realistic view of the typical exam preparation and licensure process as well as an interactive tool that visitors can use to predict when they might complete the CPA exam. The timeline generates an exam plan to help CPA candidates determine when to study, when to schedule the exam and which sections to take first.
- **Find Your Fit** is an interactive tool that helps place students on the path to their desired career after graduation and completion of the CPA exam. Students can choose the type and size of organization where they would like to work as well as their preferred industry, practice area, specialization, etc. The tool then generates a profile, based on students' selections, that offers information that can help them achieve their career goals.

The site also includes resume and interviewing tips. A video simulation lets visitors mimic the experience of going through the interview process with the interviewer on the screen asking the job candidate questions about his or her college experience and future career plans and taking notes. Video profiles highlight the daily lives of new CPAs across industry and specialty areas. And each weekday, the site features Daily Words of Wisdom, humorous yet insightful phrases that are linked to related site content ranging from salaries to CPA exam preparation. ♦



Are you up to speed on all of the new tax laws?



Sidney Kess



Barbara Weltman

Kess on Legislation 2010: Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act



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Inside AICPA

Institute announces scholarship winners...
Melancon named Association Executive of the Year...Where to Turn

TWO AICPA SCHOLARSHIPS AWARDED

The Institute announced the winners of two scholarships—the AICPA/Accountemps Student Scholarship and the John L. Carey Scholarship.

The AICPA/Accountemps Student Scholarship is awarded to accounting students with a minimum 3.0 grade-point average who demonstrate leadership, academic excellence and future career interests in accounting and business. The AICPA administers the program, and Accountemps funds the \$2,500 individual scholarships. The 2010 winners, who were chosen from more than 340 applicants, are:

- Heather Bergman, University of Montana
- Jennifer Brown, University of Portland, Ore.
- Melissa Cheesman, Seattle University
- Tyson Miller, University of Oklahoma
- Lydia Virino, North Carolina State University

The John L. Carey Scholarship is awarded to students in the liberal arts, science and other nonbusiness majors to pursue graduate accounting degrees and become CPAs. Each winner received a \$5,000 scholarship from the AICPA Foundation. The 2010 winners and their graduate schools are:

- Michael Bargar, The Ohio State University
- Michael Behr, University of Rochester, N.Y.
- Lora Dushanova, University of Southern California
- John Enders, Wake Forest University, N.C.
- Amanda Estevez, University of Texas–Austin
- Jonathan Giammarco, University of Texas–Austin

- Sarah Gustafson, University of Southern California
- Michele Keener, University of Montana
- Jayson Remmelts, University of Pennsylvania
- Katherine Sartoski, Texas A&M University

The deadline to apply for either scholarship for 2011–2012 is April 1, 2011. For more information on these scholarships, visit tinyurl.com/2a2hw4c.

ASSOCIATION PUBLICATION NAMES AICPA PRESIDENT AND CEO EXECUTIVE OF THE YEAR

Barry Melancon, AICPA president and CEO, was named Association Executive of the Year by Association TRENDS, a news publication for association leaders.



Barry Melancon

The publication has presented the title annually at its Salute to Association Excellence event, held last month in Washington, D.C., to the top association executive since 1982. Melancon was recognized for leading the AICPA in reinventing its culture and responding to changes confronting the profession—from overseeing the move of one of the Institute's major offices from New Jersey to North Carolina in 2006 to communicating with members around the world on a daily basis.

"I am honored to be selected by Association TRENDS as the Association Executive of the Year," said Melancon in a prepared statement. "In my mind this is an AICPA award, reflecting on our work as an organization, which only happens because of our member volunteers, our tremendous staff and

executive team, and our partnerships, including those with the state CPA societies." ❖

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Advertising—Display (<i>Journal of Accountancy</i> , <i>The Tax Adviser</i>)	800-873-1677
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(This list was compiled as of Jan. 14, 2011. More current information may be available from the respective standard setter.
Note: The policy for updating the list of exposure drafts and working drafts is that a document should remain on the list until a final document has been issued or the project has been dropped. However, no comments will be received after the comments deadline has expired.
 The list is not all-inclusive but is intended to present the exposure drafts and working drafts of particular interest to professional accountants.)

Issue Date	Title or Description	Comment Deadline	Issue Date	Title or Description	Comment Deadline
EXPOSURE DRAFTS			ARSC (AICPA)		
FASB			11/30/10	Proposed Statement on Standards for Accounting and Review Services, The Use of the Accountant's Name in a Document or Communication Containing Unaudited Financial Statements That Have Not Been Compiled or Reviewed	4/29/11
12/17/10	Proposed Accounting Standards Update, Other Expenses (Topic 720): Fees Paid to the Federal Government by Health Insurers (a consensus of the FASB Emerging Issues Task Force)	4/18/11	7/8/10	Proposed Statement on Standards for Accounting and Review Services, The Applicability of Statements on Standards for Accounting and Review Services	10/8/10
12/17/10	Proposed Accounting Standards Update, Health Care Entities (Topic 954): Presentation and Disclosure of Net Revenue, Provision for Bad Debts, and the Allowance for Doubtful Accounts (a consensus of the FASB Emerging Issues Task Force)	2/15/11	ASB (AICPA)		
12/9/10	Proposed Accounting Standards Update, Receivables (Topic 310): Deferral of the Effective Date of Disclosures about Troubled Debt Restructurings in Update No. 2010-20	12/24/10	12/21/10	Proposed Statement on Auditing Standards, Alert as to the Intended Use of the Auditor's Written Communication	4/29/11
11/3/10	Proposed Accounting Standards Update, Transfers and Servicing (Topic 860): Reconsideration of Effective Control for Repurchase Agreements	1/15/11	11/9/10	Proposed Revised Statement on Auditing Standards, Financial Statements Prepared in Accordance With a Financial Reporting Framework Generally Accepted in Another Country	1/31/11
10/12/10	Proposed Accounting Standards Update, Receivables (Topic 310): Clarifications to Accounting for Troubled Debt Restructurings by Creditors	12/13/10	7/19/10	Proposed Statement on Auditing Standards, Letters for Underwriters and Certain Other Requesting Parties (Redrafted)	9/30/10
9/1/10	Proposed Accounting Standards Update, Compensation—Retirement Benefits—Multiemployer Plans (Subtopic 715-80): Disclosure about an Employer's Participation in a Multiemployer Plan	11/1/10	7/8/10	Proposed Statement on Auditing Standards, Revised Applicability of Statement on Auditing Standards No. 116, Interim Financial Information	10/8/10
8/17/10	Proposed Accounting Standards Update, Leases (Topic 840)	12/15/10	7/8/10	Proposed Statement on Auditing Standards, Interim Financial Information (Redrafted)	10/8/10
7/20/10	Proposed Accounting Standards Update, Contingencies (Topic 450): Disclosure of Certain Loss Contingencies	8/20/10	6/1/10	Proposed Statement on Auditing Standards, Filings With the U.S. Securities and Exchange Commission Under the Securities Act of 1933	8/2/10
6/29/10	Proposed Accounting Standards Update, Fair Value Measurements and Disclosures (Topic 820): Amendments for Common Fair Value Measurements and Disclosure Requirements in U.S. GAAP and IFRSs	9/7/10	9/30/09	Proposed Statement on Auditing Standards, Reporting on Compliance With Aspects of Contractual Agreements or Regulatory Requirements in Connection With Audited Financial Statements (Redrafted)	12/31/09
6/24/10	Proposed Accounting Standards Update, Revenue Recognition (Topic 605): Revenue from Contracts with Customers	10/22/10	OTHER (AICPA)		
5/26/10	Proposed Accounting Standards Update, Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities: Financial Instruments (Topic 825) and Derivatives and Hedging (Topic 815)	9/30/10	9/4/09	Omnibus Proposal of Professional Ethics Division Interpretations and Rulings	11/6/09
5/26/10	Proposed Accounting Standards Update, Comprehensive Income (Topic 220): Statement of Comprehensive Income	9/30/10	3/13/09	Generally Accepted Privacy Principles	4/15/09
3/11/10	Proposed Statement of Financial Accounting Concepts, Conceptual Framework for Financial Reporting: The Reporting Entity	7/16/10	11/26/08	Proposed Statements on Standards for Tax Services	5/15/09
10/9/08	Going Concern	12/8/08	SEC		
8/7/08	Earnings per Share—an amendment of FASB Statement No. 128 (Revision of Exposure Draft Issued September 30, 2005)	12/5/08	5/20/09	Custody of Funds or Securities of Clients by Investment Advisers	7/28/09
6/6/08	Accounting for Hedging Activities (an amendment of FASB Statement No. 133)	8/15/08	2/3/09	Roadmap for the Potential Use of Financial Statements Prepared in Accordance With International Financial Reporting Standards by U.S. Issuers	4/20/09
			GASB		
			11/24/10	Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position	2/25/11
			6/16/10	Pension Accounting and Financial Reporting by Employers	9/17/10
			IFAC		
			12/15/10	Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities	6/15/11

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Issue Date	Title or Description	Comment Deadline
12/10/10	Proposed Redrafted International Education Standard, IES 7, Continuing Professional Development: A Program of Lifelong Learning and Continuing Development of Professional Competence	3/8/11
11/4/10	IFAC Policy Position Paper #4, A Public Interest Framework for the Accountancy Profession	3/25/11
10/28/10	Proposed International Standard on Related Services, ISRS 4410 (Revised), Compilation Engagements	3/31/11
10/13/10	International Auditing Practice Statements, Proposals Relating to the Withdrawal of Existing IAPs and Clarification of the Status and Authority of New IAPs and Proposed IAPs 1000, Special Considerations in Auditing Complex Financial Instruments	2/11/11
7/15/10	ISA 315 (Revised), Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment and ISA 610 (Revised), Using the Work of Internal Auditors	11/15/10
4/28/10	Proposed International Standard on Assurance Engagements (ISAE) 3420, Assurance Reports on the Process to Compile Pro Forma Financial Information Included in a Prospectus	9/30/10
2/19/10	Proposed International Public Sector Accounting Standard, Service Concession Arrangements: Grantor	6/30/10
FASAB 1/5/11	Deferral of the Effective Date of SFAS 38, Accounting for Federal Oil and Gas Resources	2/7/11
1/5/11	Technical Bulletin 2011-1, Accounting for Federal Natural Resources Other Than Oil and Gas	1/31/11
9/13/10	Measurement of the Elements of Accrual-Basis Financial Statements in Periods After Initial Recording	11/30/10
5/4/10	Definitional Changes Related to Deferred Maintenance and Repairs: Amending Statement of Federal Financial Accounting Standards 6, Accounting for Property, Plant, and Equipment	6/25/10

Issue Date	Title or Description	Comment Deadline
GAO 8/2010	Government Auditing Standards, 2010 Exposure Draft	11/22/10
PCAOB 2/26/08	Proposed Auditing Standard—Engagement Quality Review and Conforming Amendment to the Board's Interim Quality Control Standards	5/12/08
10/17/07	An Audit of Internal Control That Is Integrated With an Audit of Financial Statements: Guidance for Auditors of Smaller Public Companies	12/17/07
5/24/07	Amendments to Limit Board Rule 4003's Fixed Periodic Inspection Requirement to Firms That Regularly Issue Audit Reports	7/23/07
4/3/07	Proposed Auditing Standard—Evaluating Consistency of Financial Statements and Proposed Amendments to Interim Auditing Standards	5/18/07
12/19/06	Amendments to Board Rules Relating to Inspections	2/16/07
5/23/06	Proposed Rules on Succeeding to the Registration Status of a Predecessor Firm	7/24/06
5/23/06	Proposed Rules on Periodic Reporting by Registered Public Accounting Firms	7/24/06
10/26/04	Proposed Rule on Procedures Relating to Subpoena Requests in Disciplinary Proceedings	11/29/04

NONAUTHORITATIVE WORKING DRAFTS

FinREC (AICPA)

10/9/09	Audit and Accounting Guide, Entities With Oil and Gas Producing Activities	12/11/09
9/10/08	Audit and Accounting Guide, Gaming	12/9/08

INFORMATION

The initials stand for the following organizations. Exposure drafts are available online at the Web addresses below or copies may be obtained at the address in parentheses (unless otherwise indicated).

FASB—	Financial Accounting Standards Board (Order Department, Financial Accounting Standards Board, 401 Merritt 7, P.O. Box 5116, Norwalk, CT 06856-5116); www.fasb.org
GASB—	Governmental Accounting Standards Board (Order Department, Governmental Accounting Standards Board, 401 Merritt 7, P.O. Box 5116, Norwalk, CT 06856-5116); www.gasb.org
AICPA—	American Institute of CPAs (AICPA, 220 Leigh Farm Road, Durham, NC 27707-8110). The Institute publishes exposure drafts and working drafts exclusively on the Web at www.aicpa.org . Print copies are not available.
IASB—	International Accounting Standards Board (International Accounting Standards Board, 30 Cannon Street, London EC4M 6XH, United Kingdom); www.iasb.org
IFAC—	International Federation of Accountants (International Federation of Accountants, 545 Fifth Avenue, 14th Floor, New York, NY 10017); www.ifac.org

SEC—	Securities and Exchange Commission (Securities and Exchange Commission, 100 F Street, N.E., Washington, DC 20549); www.sec.gov
FASAB—	Federal Accounting Standards Advisory Board (Federal Accounting Standards Advisory Board, 441 G Street, N.W., Suite 6814, Washington, DC 20548); www.fasab.gov
GAO—	U.S. Government Accountability Office (available only in electronic format); www.gao.gov
PCAOB—	Public Company Accounting Oversight Board (Public Company Accounting Oversight Board, 1666 K Street, N.W., Washington, DC 20006-2803); www.pcaobus.org

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CLARIFIED STATEMENTS ON AUDITING STANDARDS

Note: All clarified Statements on Auditing Standards (SASs) will have the same effective date. Upon the issuance of all clarified SASs, one SAS will be issued containing all clarified SASs in codified format.

Statement on Auditing Standards—Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures

Statement on Auditing Standards (SAS) *Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures* supersedes SAS No. 57, *Auditing Accounting Estimates* (AICPA, Professional Standards, vol. 1, AU sec. 342), and SAS No. 101, *Auditing Fair Value Measurements and Disclosures* (AICPA, Professional Standards, vol. 1, AU sec. 328).

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Identifying and Assessing the Risks of Material Misstatement/A45–A51

Responding to the Assessed Risks of Material Misstatement/A52–A107

Further Substantive Procedures to Respond to Significant Risks/A108–A121

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Exhibit A: Examples of Accounting Estimates/A136

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Conforming Amendment to Statement on Auditing Standards, The Auditor's Communication With Those Charged With Governance (Redrafted)/A138

INTRODUCTION

Scope of This Statement on Auditing Standards

1. This Statement on Auditing Standards (SAS) addresses the auditor's responsibilities relating to accounting estimates, including fair value accounting estimates and related disclosures, in an audit of financial statements. Specifically, it expands on how the clarified SAS *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (Redrafted), the clarified SAS *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (Redrafted), and other relevant SASs are to be applied in relation to accounting estimates. It also includes requirements and guidance related to misstatements of individual accounting estimates and indicators of possible management bias.

Nature of Accounting Estimates

2. Some financial statement items cannot be measured precisely but can only be estimated. For purposes of this SAS, such financial statement items are referred to as *accounting estimates*. The nature and reliability of information available to management

to support the making of an accounting estimate varies widely, which thereby affects the degree of estimation uncertainty associated with accounting estimates. The degree of estimation uncertainty affects, in turn, the risks of material misstatement of accounting estimates, including their susceptibility to unintentional or intentional management bias. (Ref: par. A1–A10, A136)

3. The measurement objective of accounting estimates can vary, depending on the applicable financial reporting framework and the financial item being reported.¹ The measurement objective for some accounting estimates is to forecast the outcome of one or more transactions, events, or conditions giving rise to the need for the accounting estimate. For other accounting estimates, including many fair value accounting estimates, the measurement objective is different and is expressed in terms of the value of a current transaction or financial statement item based on conditions prevalent at the measurement date, such as estimated market price for a particular type of asset or liability. For example, the applicable financial reporting framework may require fair value measurement based on an assumed hypothetical current transaction between knowledgeable, willing parties (sometimes referred to as *market participants* or equivalent) in an arm's length transaction, rather than the settlement of a transaction at some past or future date.²

4. A difference between the outcome of an accounting estimate and the amount originally recognized or disclosed in the financial statements does not necessarily represent a misstatement of the financial statements; rather, it could be an outcome of estimation uncertainty (see paragraph 2). This is particularly the case for fair value accounting estimates because any observed outcome may be affected by events or conditions subsequent to the date at which the measurement is estimated for purposes of the financial statements.

Effective Date

5. This SAS is effective for audits of financial statements for periods ending on or after December 15, 2012.

OBJECTIVE

6. The objective of the auditor is to obtain sufficient

1. Paragraph 13 of the clarified Statement on Auditing Standards (SAS) *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards* defines *financial report framework* and the term *fair presentation framework*.

2. Different definitions of *fair value* may exist among financial reporting frameworks.

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appropriate audit evidence about whether, in the context of the applicable financial reporting framework

- a. accounting estimates, including fair value accounting estimates, in the financial statements, whether recognized or disclosed, are reasonable and
- b. related disclosures in the financial statements are adequate.

DEFINITIONS

7. For purposes of generally accepted auditing standards, the following terms have the meanings attributed as follows:

Accounting estimate. An approximation of a monetary amount in the absence of a precise means of measurement. This term is used for an amount measured at fair value when there is estimation uncertainty, as well as for other amounts that require estimation. When this SAS addresses only accounting estimates involving measurement at fair value, the term *fair value accounting estimates* is used.

Auditor's point estimate or auditor's range. The amount or range of amounts, respectively, derived from audit evidence for use in evaluating the recorded or disclosed amount(s).

Estimation uncertainty. The susceptibility of an accounting estimate and related disclosures to an inherent lack of precision in its measurement.

Management bias. A lack of neutrality by management in the preparation and presentation of information.

Management's point estimate. The amount selected by management for recognition or disclosure in the financial statements as an accounting estimate.

Outcome of an accounting estimate. The actual monetary amount that results from the resolution of the underlying transaction(s), event(s), or condition(s) addressed by the accounting estimate.

REQUIREMENTS

Risk Assessment Procedures and Related Activities

8. When performing risk assessment procedures and related activities to obtain an understanding of the entity and its environment, including the entity's internal control, as required by the clarified SAS *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (Redrafted),³ the auditor should obtain an understanding of the following in order to provide a basis for the identification and assessment of the risks of material misstatement for accounting estimates: (Ref: par. A11)

- a. The requirements of the applicable financial reporting framework relevant to accounting estimates, including related disclosures. (Ref: par. A12–A14)
- b. How management identifies those transactions,

events, and conditions that may give rise to the need for accounting estimates to be recognized or disclosed in the financial statements. In obtaining this understanding, the auditor should make inquiries of management about changes in circumstances that may give rise to new, or the need to revise existing, accounting estimates. (Ref: par. A15–A20)

- c. How management makes the accounting estimates and the data on which they are based, including (Ref: par. A21–A22)
 - i. the method(s), including, when applicable, the model, used in making the accounting estimate; (Ref: par. A23–A25)
 - ii. relevant controls; (Ref: par. A26–A27)
 - iii. whether management has used a specialist; (Ref: par. A28–A29)
 - iv. the assumptions underlying the accounting estimates; (Ref: par. A30–A35)
 - v. whether there has been or ought to have been a change from the prior period in the method(s) or assumption(s) for making the accounting estimates and, if so, why; and (Ref: par. A36)
 - vi. whether and, if so, how management has assessed the effect of estimation uncertainty. (Ref: par. A37)

9. The auditor should review the outcome of accounting estimates included in the prior period financial statements or, when applicable, their subsequent reestimation for the purpose of the current period. The nature and extent of the auditor's review takes account of the nature of the accounting estimates and whether the information obtained from the review would be relevant to identifying and assessing risks of material misstatement of accounting estimates made in the current period financial statements. However, the review is not intended to call into question the auditor's professional judgments made in the prior periods that were based on information available at the time. (Ref: par. A38–A44)

Identifying and Assessing the Risks of Material Misstatement

10. In identifying and assessing the risks of material misstatement, as required by the clarified SAS *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (Redrafted),⁴ the auditor should evaluate the degree of estimation uncertainty associated with an accounting estimate. (Ref: par. A45–A46)

11. The auditor should determine whether, in the auditor's judgment, any of those accounting estimates that have been identified as having high estimation uncertainty give rise to significant risks. (Ref: par. A47–A51)

Responding to the Assessed Risks of Material Misstatement

12. Based on the assessed risks of material misstatement, the auditor should determine (Ref: par. A52)

- a. whether management has appropriately applied the requirements of the applicable financial reporting framework relevant to the accounting estimate and (Ref: par. A53–A57)
- b. whether the methods for making the accounting estimates are appropriate and have been applied consistently and whether changes from the prior period, if any, in accounting estimates or the method for making them are appropriate in the circumstances. (Ref: par. A58–A59)

13. In responding to the assessed risks of material misstatement, as required by the clarified SAS *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (Redrafted),⁵ the auditor should undertake one or more of the following, taking into account the nature of the accounting estimate: (Ref: par. A60–A62)

- a. Determine whether events occurring up to the date of the auditor's report provide audit evidence regarding the accounting estimate. (Ref: par. A63–A67)
- b. Test how management made the accounting estimate and the data on which it is based. In doing so, the auditor should evaluate whether (Ref: par. A68–A71)
 - i. the method of measurement used is appropriate in the circumstances, (Ref: par. A72–A77)
 - ii. the assumptions used by management are reasonable in light of the measurement objectives of the applicable financial reporting framework, and (Ref: par. A78–A89)
 - iii. the data on which the estimate is based is sufficiently reliable for the auditor's purposes. (Ref: par. A70)
- c. Test the operating effectiveness of the controls over how management made the accounting estimate, together with appropriate substantive procedures. (Ref: par. A90–A92)
- d. Develop a point estimate or range to evaluate management's point estimate. For this purpose (Ref: par. A93–A97)
 - i. if the auditor uses assumptions or methods that differ from management's, the auditor should obtain an understanding of management's assumptions or methods sufficient to establish that the auditor's point estimate or range takes into account relevant variables and to evaluate any significant differences from management's point estimate. (Ref: par. A98)
 - ii. if the auditor concludes that it is appropriate to use a range, the auditor should narrow the range, based on audit evidence available, until all outcomes within the range are considered reasonable. (Ref: par. A99–A101)

14. In determining the matters identified in paragraph 12 or in responding to the assessed risks of material misstatement in accordance with paragraph 13, the auditor should consider whether specialized skills or knowledge in relation to one or more

3. Paragraphs 5–6 and 11–12 of the clarified SAS *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (Redrafted).

4. Paragraph 25 of the clarified SAS *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (Redrafted).

5. Paragraphs 5–6 of the clarified SAS *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (Redrafted).

aspects of the accounting estimates are required in order to obtain sufficient appropriate audit evidence. (Ref: par. A102–A107)

Further Substantive Procedures to Respond to Significant Risks (Ref: par. A108)

Estimation Uncertainty

15. For accounting estimates that give rise to significant risks, in addition to other substantive procedures performed to meet the requirements of the clarified SAS *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (Redrafted),⁶ the auditor should evaluate the following:

- a. How management has considered alternative assumptions or outcomes and why it has rejected them or how management has otherwise addressed estimation uncertainty in making the accounting estimate (Ref: par. A109–A112)
- b. Whether the significant assumptions used by management are reasonable (Ref: par. A113–A115)
- c. When relevant to the reasonableness of the significant assumptions used by management or the appropriate application of the applicable financial reporting framework, management's intent to carry out specific courses of action and its ability to do so (Ref: par. A116)

16. If, in the auditor's judgment, management has not addressed adequately the effects of estimation uncertainty on the accounting estimates that give rise to significant risks, the auditor should, if considered necessary, develop a range with which to evaluate the reasonableness of the accounting estimate. (Ref: par. A117–A118)

Recognition and Measurement Criteria

17. For accounting estimates that give rise to significant risks, the auditor should obtain sufficient appropriate audit evidence about whether

- a. management's decision to recognize or not recognize the accounting estimates in the financial statements and (Ref: par. A119–A120)
 - b. the selected measurement basis for the accounting estimates (Ref: par. A121)
- are in accordance with the requirements of the applicable financial reporting framework.

Evaluating the Reasonableness of the Accounting Estimates and Determining Misstatements

18. The auditor should evaluate, based on the audit evidence, whether the accounting estimates in the financial statements are either reasonable in the context of the applicable financial reporting framework or are misstated. (Ref: par. A122–A127)

Disclosures Related to Accounting Estimates

19. The auditor should obtain sufficient appropriate audit evidence about whether the disclosures in the financial statements related to accounting esti-

mates are in accordance with the requirements of the applicable financial reporting framework. (Ref: par. A128–A129)

20. For accounting estimates that give rise to significant risks, the auditor also should evaluate the adequacy of the disclosure of estimation uncertainty in the financial statements in the context of the applicable financial reporting framework. (Ref: par. A108, A130–A132)

Indicators of Possible Management Bias

21. The auditor should review the judgments and decisions made by management in the making of accounting estimates to identify whether indicators of possible management bias exist. Indicators of possible management bias do not, themselves, constitute misstatements for the purposes of drawing conclusions on the reasonableness of individual accounting estimates. (Ref: par. A133–A134)

Documentation

22. The auditor should include in the audit documentation⁷

- a. for those accounting estimates that give rise to significant risks, the basis for the auditor's conclusions about the reasonableness of accounting estimates and their disclosure and
- b. indicators of possible management bias, if any. (Ref: par. A135)

APPLICATION AND OTHER EXPLANATORY MATERIAL

Nature of Accounting Estimates (Ref: par. 2)

A1. Because of the uncertainties inherent in business activities, some financial statement items can only be estimated. Further, the specific characteristics of an asset, a liability, or a component of equity or the basis or method of measurement prescribed by the financial reporting framework may give rise to the need to estimate a financial statement item. Some financial reporting frameworks prescribe specific methods of measurement and the disclosures that are required to be made in the financial statements whereas other financial reporting frameworks are less specific.

A2. Some accounting estimates involve relatively low estimation uncertainty and may give rise to lower risks of material misstatements. For example

- accounting estimates arising in entities that engage in business activities that are not complex.
- accounting estimates that are frequently made and updated because they relate to routine transactions.
- accounting estimates derived from data that is readily available, such as published interest rate data or exchange-traded prices of securities. Such data may be referred to as *observable* in the context of a fair value accounting estimate.
- fair value accounting estimates in which the method of measurement prescribed by the

applicable financial reporting framework is simple and applied easily to the asset or liability requiring measurement at fair value.

- fair value accounting estimates in which the model used to measure the accounting estimate is well-known or generally accepted, provided that the assumptions or inputs to the model are observable.

A3. However, for some accounting estimates, relatively high estimation uncertainty may exist, particularly when they are based on significant assumptions. For example

- accounting estimates relating to the outcome of litigation.
- fair value accounting estimates for derivative financial instruments not publicly traded.
- fair value accounting estimates for which a highly specialized entity-developed model is used or for which there are assumptions or inputs that cannot be observed in the marketplace.

A4. The degree of estimation uncertainty varies based on the nature of the accounting estimate, the extent to which there is a generally accepted method or model used to make the accounting estimate, and the subjectivity of the assumptions used to make the accounting estimate. In some cases, estimation uncertainty associated with an accounting estimate may be so great that the recognition criteria in the applicable financial reporting framework are not met, and the accounting estimate cannot be made.

A5. Not all financial statement items requiring measurement at fair value involve estimation uncertainty. For example, this may be the case for some financial statement items when an active and open market exists that provides readily available and reliable information on the prices at which actual exchanges occur, in which case the existence of published price quotations ordinarily is the best audit evidence of fair value. However, estimation uncertainty may exist even when the valuation technique and data are well-defined. For example, valuation of securities quoted on an active and open market at the listed market price may require adjustment if the holding is significant in relation to the market or is subject to restrictions in marketability. In addition, general economic circumstances prevailing at the time (for example, illiquidity in a particular market) may affect estimation uncertainty.

A6. Additional examples of situations when accounting estimates, other than fair value accounting estimates, may be required include the following:

- Allowance for doubtful accounts
- Inventory obsolescence
- Warranty obligations
- Depreciation method or asset useful life
- Provision against the carrying amount of an investment when uncertainty regarding its recoverability exists
- Outcome of long-term contracts
- Costs arising from litigation settlements and judgments

A7. Additional examples of situations when fair value accounting estimates may be required include the following:

- Complex financial instruments, which are not

6. Paragraph 19 of the clarified SAS *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (Redrafted).

7. See the clarified SAS *Audit Documentation* (Redrafted).

- traded in an active and open market
- Share-based payments
- Property or equipment held for disposal
- Certain assets or liabilities acquired in a business combination, including goodwill and intangible assets
- Transactions involving the exchange of assets or liabilities between independent parties without monetary consideration (for example, a non-monetary exchange of plant facilities in different lines of business)

A8. Estimation involves judgments based on information available when the financial statements are prepared. For many accounting estimates, these include making assumptions about matters that are uncertain at the time of estimation. The auditor is not responsible for predicting future conditions, transactions, or events that, if known at the time of the audit, might have significantly affected management's actions or the assumptions used by management.

Management Bias

A9. Financial reporting frameworks often call for neutrality (that is, freedom from bias). However, accounting estimates are imprecise and can be influenced by management judgment. Such judgment may involve unintentional or intentional management bias (for example, as a result of motivation to achieve a desired result). The susceptibility of an accounting estimate to management bias increases with the subjectivity involved in making it. Unintentional management bias and the potential for intentional management bias are inherent in subjective decisions that are often required in making an accounting estimate. For continuing audits, indicators of possible management bias identified during the audit of the preceding periods influence the planning and risk identification and assessment activities of the auditor in the current period.

A10. Management bias can be difficult to detect at an account level. It may only be identified when considered in the aggregate of groups of accounting estimates or all accounting estimates or when observed over a number of accounting periods. Although some form of management bias is inherent in subjective decisions, in making such judgments, there may be no intention by management to mislead the users of financial statements. However, when intention to mislead exists, management bias is fraudulent in nature.

Risk Assessment Procedures and Related Activities (Ref: par. 8)

A11. The risk assessment procedures and related activities required by paragraphs 8–9 of this SAS assist the auditor in developing an expectation of the nature and type of accounting estimates that an entity may have. The nature and extent of the risk assessment procedures and activities are matters of professional judgment. The auditor's primary consideration is whether the understanding that has been obtained is sufficient to identify and assess the risks of material misstatement in relation to accounting estimates and to plan the nature, timing, and extent of further audit procedures. When the risk

of material misstatement related to an accounting estimate has been significantly reduced by audit evidence relating to events occurring after management has made the estimate (for example, if litigation has been settled, the entity has sold an impaired asset, or receivables have been collected), the nature and extent of the procedures and activities required by paragraphs 8(c) and 9 may be significantly reduced or may not be necessary at all.

Obtaining an Understanding of the Requirements of the Applicable Financial Reporting Framework (Ref: par. 8(a))

A12. Obtaining an understanding of the requirements of the applicable financial reporting framework assists the auditor in determining, for example, whether it

- prescribes certain conditions for the recognition,⁸ or methods for the measurement, of accounting estimates.
- specifies certain conditions that permit or require measurement at a fair value.
- specifies required or permitted disclosures.

Obtaining this understanding also provides the auditor with a basis for discussion with management about how management has applied those requirements relevant to the accounting estimate and the auditor's determination of whether they have been appropriately applied.

A13. Financial reporting frameworks may provide guidance for management on determining point estimates when alternatives exist. For example, some financial reporting frameworks require that the point estimate selected be the alternative that reflects management's judgment of the most likely outcome;⁹ others may require the use of a discounted probability-weighted expected value. In some cases, management may be able to make a point estimate directly. In other cases, management may be able to make a reliable point estimate only after considering alternative assumptions or outcomes from which it is able to determine a point estimate.

A14. Financial reporting frameworks may require the disclosure of information concerning the significant assumptions to which the accounting estimate is particularly sensitive. Furthermore, when a high degree of estimation uncertainty exists, some financial reporting frameworks do not permit an accounting estimate to be recognized in the financial statements, but certain disclosures may be required in the notes to the financial statements.

Obtaining an Understanding of How Management Identifies the Need for Accounting Estimates (Ref: par. 8(b))

A15. The preparation of the financial statements requires management to determine whether a transaction, an event, or a condition gives rise to the need to make an accounting estimate and that all neces-

sary accounting estimates have been recognized, measured, and disclosed in the financial statements in accordance with the applicable financial reporting framework.

A16. Management's identification of transactions, events, and conditions that give rise to the need for accounting estimates is likely to be based on

- management's knowledge of the entity's business and the industry in which it operates.
- management's knowledge of the implementation of business strategies in the current period.
- when applicable, management's cumulative experience of preparing the entity's financial statements in prior periods.

In such cases, the auditor may obtain an understanding of how management identifies the need for accounting estimates primarily through inquiry of management. In other cases, when management's process is more structured (for example, when management has a formal risk management function), the auditor may perform risk assessment procedures directed at the methods and practices followed by management for periodically reviewing the circumstances that give rise to the accounting estimates and reestimating the accounting estimates as necessary. The completeness of accounting estimates is often an important consideration of the auditor, particularly accounting estimates relating to liabilities.

A17. The auditor's understanding of the entity and its environment obtained during the performance of risk assessment procedures, together with other audit evidence obtained during the course of the audit, assist the auditor in identifying circumstances or changes in circumstances that may give rise to the need for an accounting estimate.

A18. Inquiries of management about changes in circumstances may include, for example, inquiries about whether

- the entity has engaged in new types of transactions that may give rise to accounting estimates.
- terms of transactions that gave rise to accounting estimates have changed.
- accounting policies relating to accounting estimates have changed as a result of changes to the requirements of the applicable financial reporting framework or otherwise.
- regulatory or other changes outside the control of management have occurred that may require management to revise, or make new, accounting estimates.
- new conditions or events have occurred that may give rise to the need for new or revised accounting estimates.

A19. During the audit, the auditor may identify transactions, events, and conditions that give rise to the need for accounting estimates that management failed to identify. The clarified SAS *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (Redrafted)¹⁰ addresses circumstances in which the auditor identifies risks of material misstatement that

8. Most financial reporting frameworks require incorporation in the balance sheet or income statement of items that satisfy their criteria for recognition. Disclosure of accounting policies or adding notes to the financial statements does not rectify a failure to recognize such items, including accounting estimates.

9. Different financial reporting frameworks may use different terminology to describe point estimates determined in this way.

10. Paragraph 17 of the clarified SAS *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (Redrafted).

management failed to identify, including determining whether a significant deficiency or material weakness in internal control exists with regard to the entity's risk assessment processes.

Considerations Specific to Smaller, Less Complex Entities

A20. Obtaining this understanding for smaller entities is often less complex because their business activities are often limited, and transactions are less complex. Further, often, a single person (for example, the owner-manager) identifies the need to make an accounting estimate, and the auditor may focus inquiries accordingly.

Obtaining an Understanding of How Management Makes the Accounting Estimates (Ref: par. 8(c))

A21. The preparation of the financial statements also requires management to establish financial reporting processes for making accounting estimates, including adequate internal control. Such processes include the following:

- Selecting appropriate accounting policies and prescribing estimation processes, including appropriate estimation or valuation techniques, including, when applicable, the appropriate models
- Developing or identifying relevant data and assumptions that affect accounting estimates
- Periodically reviewing the circumstances that give rise to the accounting estimates and reestimating the accounting estimates as necessary

A22. Matters that the auditor may consider in obtaining an understanding of how management makes the accounting estimates include, for example

- the types of accounts or transactions to which the accounting estimates relate (for example, whether the accounting estimates arise from the recording of routine and recurring transactions or whether they arise from nonrecurring or unusual transactions).
- whether and, if so, how management has used recognized measurement techniques for making particular accounting estimates.
- whether the accounting estimates were made based on data available at an interim date and, if so, whether and how management has taken into account the effect of events, transactions, and changes in circumstances occurring between that date and the period end.

Method of Measurement, Including the Use of Models (Ref: par. 8(c)(i))

A23. In some cases, the applicable financial reporting framework may prescribe the method of measurement for an accounting estimate (for example, a particular model that is to be used in measuring a fair value estimate). In many cases, however, the applicable financial reporting framework does not prescribe the method of measurement or may specify alternative methods for measurement.

A24. When the applicable financial reporting framework does not prescribe a particular method to be used in the circumstances, matters that the auditor

may consider in obtaining an understanding of the method or, when applicable, the model used to make accounting estimates include, for example

- how management considered the nature of the asset or liability being estimated when selecting a particular method.
- whether the entity operates in a particular business, industry, or environment in which methods commonly used to make the particular type of accounting estimate exist.

A25. There may be greater risks of material misstatement, for example, in cases when management has internally developed a model to be used to make the accounting estimate or is departing from a method commonly used in a particular business, industry, or environment.

Relevant Controls (Ref: par. 8(c)(ii))

A26. Matters that the auditor may consider in obtaining an understanding of relevant controls include, for example, the experience and competence of those who make the accounting estimates and controls related to

- how management determines the completeness, relevance, and accuracy of the data used to develop accounting estimates.
- the review and approval of accounting estimates, including the assumptions or inputs used in their development, by appropriate levels of management and, when appropriate, those charged with governance.
- the segregation of duties between those committing the entity to the underlying transactions and those responsible for making the accounting estimates, including whether the assignment of responsibilities appropriately takes account of the nature of the entity and its products or services (for example, in the case of a large financial institution, relevant segregation of duties may include an independent function responsible for estimation and validation of fair value pricing of the entity's proprietary financial products staffed by individuals whose remuneration is not tied to such products).
- services provided by a service organization, if any, to provide fair value or other accounting estimates measurements or the data that supports the measurement. When an entity uses a service organization, the clarified SAS *Audit Considerations Relating to an Entity Using a Service Organization* applies.

A27. Other controls may be relevant to making the accounting estimates, depending on the circumstances. For example, if the entity uses specific models for making accounting estimates, management may put into place specific policies and procedures around such models. These may include, for example, those established over

- the design and development or selection of a particular model for a particular purpose.
- the use of the model.
- the maintenance and periodic validation of the integrity of the model.
- security, such as controls that prevent changes to the model or data without authorization.

*Management's Use of Specialists*¹¹ (Ref: par. 8(c)(iii))
A28. Management may have, or the entity may employ individuals with, the experience and competence necessary to make estimates. In some cases, however, management may need to engage a specialist to make estimates or assist in making them. This need may arise because of, for example

- the specialized nature of the matter requiring estimation (for example, the measurement of mineral or hydrocarbon reserves in extractive industries).
- the technical nature of the models required to meet the relevant requirements of the applicable financial reporting framework, as may be the case in certain measurements at fair value.
- the unusual or infrequent nature of the condition, transaction, or event requiring an accounting estimate.

Considerations Specific to Smaller, Less Complex Entities

A29. Discussion with the owner-manager early in the audit process about the nature of any accounting estimates, the completeness of the required accounting estimates, and the adequacy of the estimating process may assist the owner-manager in determining the need to use a specialist.

Assumptions (Ref: par. 8(c)(iv))

A30. Assumptions may be characterized by predictions of future conditions, transactions, or events used in making an estimate and are integral components of accounting estimates. Matters that the auditor may consider in obtaining an understanding of the assumptions underlying the accounting estimates include, for example

- the nature of the assumptions, including which of the assumptions are likely to be significant assumptions.
- how management assesses whether the assumptions are relevant and complete (that is, that all relevant variables have been taken into account).
- when applicable, how management determines that the assumptions used are internally consistent.
- whether the assumptions relate to matters within the control of management (for example, assumptions about the maintenance programs that may affect the estimation of an asset's useful life) and how they conform to the entity's business plans and the external environment or to matters that are outside its control (for example, assumptions about interest rates, mortality rates, potential judicial or regulatory actions, or the variability and timing of future cash flows).
- the nature and extent of documentation, if any, supporting the assumptions.

Assumptions may be made or identified by a specialist to assist management in making the accounting

11. See the clarified SAS *Audit Evidence* (Redrafted), which addresses management's specialists. (See the proposed SAS *Using the Work of an Auditor's Specialist*, which contains a conforming amendment to the clarified SAS *Audit Evidence* (Redrafted). The purpose of the conforming amendment is to include the requirements and guidance related to management's specialists in the clarified SAS *Audit Evidence* (Redrafted)).

estimates. Such assumptions, when used by management, become management's assumptions.

A31. In some cases, assumptions may be referred to as *inputs* (for example, when management uses a model to make an accounting estimate), though the term *inputs* may also be used to refer to the underlying data to which specific assumptions are applied.

A32. Management may support assumptions with different types of information drawn from internal and external sources, the relevance and reliability of which will vary. In some cases, an assumption may be reliably based on applicable information from either external sources (for example, published interest rate or other statistical data) or internal sources (for example, historical information or previous conditions experienced by the entity). In other cases, an assumption may be more subjective (for example, when the entity has no experience or external sources from which to draw).

A33. In the case of fair value accounting estimates, assumptions reflect, or are consistent with, what knowledgeable, willing arm's length parties (sometimes referred to as *market participants* or equivalent) would use in determining fair value when exchanging an asset or settling a liability. Specific assumptions also will vary with the characteristics of the asset or liability being valued; the valuation technique used (for example, a market approach or an income approach); and the requirements of the applicable financial reporting framework.

A34. With respect to fair value accounting estimates, assumptions or inputs vary in terms of their source and bases, as follows:

- a. Those that reflect what market participants would use in pricing an asset or a liability, developed based on market data obtained from sources independent of the reporting entity (sometimes referred to as *observable inputs* or equivalent)
- b. Those that reflect the entity's own judgments about what assumptions market participants would use in pricing the asset or liability, developed based on the best information available in the circumstances (sometimes referred to as *unobservable inputs* or equivalent)

In practice, however, the distinction between (a) and (b) is not always apparent. Further, it may be necessary for management to select from a number of different assumptions used by different market participants.

A35. The extent of subjectivity, such as whether an assumption or input is observable, influences the degree of estimation uncertainty and, thereby, the auditor's assessment of the risks of material misstatement for a particular accounting estimate.

Changes in Methods or Assumptions for Making Accounting Estimates (Ref: par. 8(c)(v))

A36. In obtaining an understanding of how management makes the accounting estimates, the auditor is required to obtain an understanding about whether there has been or ought to have been a change from the prior period in the methods or assumptions for making the accounting estimates.

A specific estimation method or assumption may need to be changed in response to changes in the environment or circumstances affecting the entity or in the requirements of the applicable financial reporting framework. If management has changed the method or assumption for making an accounting estimate, it is important that management can demonstrate that the new method or assumption is more appropriate or is responsive to such changes. For example, if management changes the basis of making an accounting estimate from a liquid market approach to an illiquid market approach, the auditor challenges whether management's assumptions about the marketplace are reasonable in light of economic circumstances.

Estimation Uncertainty (Ref: par. 8(c)(vi))

A37. Matters that the auditor may consider in obtaining an understanding of whether and, if so, how management has assessed the effect of estimation uncertainty include, for example,

- whether and, if so, how management has considered alternative assumptions or outcomes by, for example, performing a sensitivity analysis to determine the effect of changes in the assumptions on an accounting estimate.
- how management determines the accounting estimate when analysis indicates a number of outcome scenarios.
- whether management monitors the outcome of accounting estimates made in the prior period and whether management has appropriately responded to the outcome of that monitoring procedure.

Reviewing Prior Period Accounting Estimates (Ref: par. 9)

A38. The nature and extent of the review of the outcome of accounting estimates included in the prior period financial statements is a matter of professional judgment. In performing the procedures required in paragraph 9, it may not be necessary to review the outcome of every accounting estimate included in the prior period.

A39. The outcome of an accounting estimate will often differ from the accounting estimate recognized in the prior period financial statements. By performing risk assessment procedures to identify and understand the reasons for such differences, the auditor may obtain

- information regarding the effectiveness of management's prior period estimation process, from which the auditor can judge the likely effectiveness of management's current process;
- audit evidence that is pertinent to the reestimation, in the current period, of prior period accounting estimates; or
- audit evidence of matters that may be required to be disclosed in the financial statements, such as estimation uncertainty.

A40. The review of prior period accounting estimates may also assist the auditor, in the current period, in identifying circumstances or conditions that increase the susceptibility of accounting estimates to, or indicate the presence of, possible management bias. The auditor's professional skepticism assists in

identifying such circumstances or conditions and in determining the nature, timing, and extent of further audit procedures.

A41. A retrospective review of management judgments and assumptions related to significant accounting estimates is also required by the clarified SAS *Consideration of Fraud in a Financial Statement Audit* (Redrafted).¹² That review is conducted as part of the requirement for the auditor to design and perform procedures to review accounting estimates for biases that could represent a risk of material misstatement due to fraud, in response to the risks of management override of controls. As a practical matter, the auditor's review of prior period accounting estimates as a risk assessment procedure in accordance with this SAS may be carried out in conjunction with the review required by the clarified SAS *Consideration of Fraud in a Financial Statement Audit* (Redrafted).

A42. The auditor may judge that a more detailed review is required for those accounting estimates that were identified during the prior period audit as having high estimation uncertainty or for those accounting estimates that have changed significantly from the prior period. On the other hand, for example, for accounting estimates that arise from the recording of routine and recurring transactions, the auditor may judge that the application of analytical procedures as risk assessment procedures is sufficient for purposes of the review.

A43. For fair value accounting estimates and other accounting estimates based on current conditions at the measurement date, more variation may exist between the fair value amount recognized in the prior period financial statements and the outcome (or the amount reestimated for the purpose of the current period). This is because the measurement objective for such accounting estimates deals with perceptions about value at a point in time, which may change significantly and rapidly as the environment in which the entity operates changes. Therefore, the auditor may focus the review on obtaining information that would be relevant to identifying and assessing risks of material misstatement. For example, in some cases, obtaining an understanding of changes in market participant assumptions that affected the outcome of a prior period fair value accounting estimate may be unlikely to provide relevant information for audit purposes. If so, then the auditor's consideration of the outcome of prior period fair value accounting estimates may be more appropriately directed toward understanding the effectiveness of management's prior estimation process (that is, management's track record) from which the auditor can judge the likely effectiveness of management's current process.

A44. A difference between the outcome of an accounting estimate and the amount recognized in the prior period financial statements does not necessarily represent a misstatement of the prior period financial statements. However, it may do so if,

12. Paragraph 32 of the clarified SAS *Consideration of Fraud in a Financial Statement Audit* (Redrafted).

for example, the difference arises from information that was available to management when the prior period's financial statements were finalized or that could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements. The clarified SAS *Subsequent Events and Subsequently Discovered Facts* addresses situations when facts become known to the auditor after the date of the auditor's report that, had they been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report. The applicable financial reporting framework may contain guidance on distinguishing between changes in accounting estimates that constitute misstatements and changes that do not and the accounting treatment required to be followed.

Identifying and Assessing the Risks of Material Misstatement

Estimation Uncertainty (Ref: par. 10)

A45. The degree of estimation uncertainty associated with an accounting estimate may be influenced by factors such as

- the extent to which the accounting estimate depends on judgment.
- the sensitivity of the accounting estimate to changes in assumptions.
- the existence of recognized measurement techniques that may mitigate the estimation uncertainty (though the subjectivity of the assumptions used as inputs may, nevertheless, give rise to estimation uncertainty).
- the length of the forecast period and the relevance of data drawn from past events to forecast future events.
- the availability of reliable data from external sources.
- the extent to which the accounting estimate is based on observable or unobservable inputs.

The degree of estimation uncertainty associated with an accounting estimate may influence the estimate's susceptibility to bias.

A46. Matters that the auditor considers in assessing the risks of material misstatement may also include the following:

- The actual or expected magnitude of an accounting estimate
- The recorded amount of the accounting estimate (that is, management's point estimate) in relation to the amount expected by the auditor to be recorded
- Whether management has used a specialist in making the accounting estimate
- The outcome of the review of prior period accounting estimates

High Estimation Uncertainty and Significant Risks (Ref: par. 11)

A47. Examples of accounting estimates that may have high estimation uncertainty include the following:

- Accounting estimates that are highly dependent upon judgment (for example, judgments about

the outcome of pending litigation or the amount and timing of future cash flows dependent on uncertain events many years in the future)

- Accounting estimates that are not calculated using recognized measurement techniques
- Accounting estimates in which the results of the auditor's review of similar accounting estimates made in the prior period financial statements indicate a substantial difference between the original accounting estimate and the actual outcome
- Fair value accounting estimates for which a highly specialized, entity-developed model is used or for which there are no observable inputs

A48. A seemingly immaterial accounting estimate may have the potential to result in a material misstatement due to the estimation uncertainty associated with the estimation (that is, the size of the amount recognized or disclosed in the financial statements for an accounting estimate may not be an indicator of its estimation uncertainty).

A49. In some circumstances, the estimation uncertainty is so high that a reasonable accounting estimate cannot be made. The applicable financial reporting framework may, therefore, preclude recognition of the item in the financial statements or its measurement at fair value. In such cases, the significant risks relate not only to whether an accounting estimate should be recognized or whether it should be measured at fair value but also to the adequacy of the disclosures. With respect to such accounting estimates, the applicable financial reporting framework may require disclosure of the accounting estimates and the high estimation uncertainty associated with them (see paragraphs A128–A131).

A50. If the auditor determines that an accounting estimate gives rise to a significant risk, the auditor is required by the clarified SAS *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (Redrafted)¹³ to obtain an understanding of the entity's controls, including control activities.

A51. In some cases, the estimation uncertainty of an accounting estimate may lead the auditor to consider whether such estimation uncertainty indicates that substantial doubt could exist about the entity's ability to continue as a going concern. AU section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1), addresses such circumstances.

Responding to the Assessed Risks of Material Misstatement (Ref: par. 12)

A52. The clarified SAS *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (Redrafted)¹⁴ requires the auditor to design and perform audit procedures whose nature, timing, and extent are responsive to the assessed risks of material misstatement in relation to accounting estimates at both the financial state-

ment and relevant assertion levels. Paragraphs A53–A121 focus on specific responses at the relevant assertion level only. Based on the assessed risks of material misstatement, the auditor is required to exercise professional judgment¹⁵ in determining the nature, timing, and extent of the procedures necessary to conclude whether management appropriately applied the requirements of the financial reporting framework, including that the methods used for making the estimates are appropriate.

Application of the Requirements of the Applicable Financial Reporting Framework (Ref: par. 12(a))

A53. Many financial reporting frameworks prescribe certain conditions for the recognition of accounting estimates and specify the methods for making them and required disclosures. Such requirements may be complex and require the application of judgment. Based on the understanding obtained in performing risk assessment procedures, the requirements of the applicable financial reporting framework that may be susceptible to misapplication or differing interpretations become the focus of the auditor's attention.

A54. Determining whether management has appropriately applied the requirements of the applicable financial reporting framework is based, in part, on the auditor's understanding of the entity and its environment. For example, the measurement of the fair value of some items, such as intangible assets acquired in a business combination, may involve special considerations that are affected by the nature of the entity and its operations.

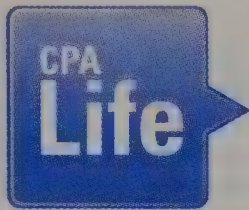
A55. In some situations, additional audit procedures, such as the inspection by the auditor of the current physical condition of an asset, may be necessary to determine whether management has appropriately applied the requirements of the applicable financial reporting framework.

A56. Collateral often is assigned for certain types of investments in debt instruments that either are required to be measured at fair value or are evaluated for possible impairment. If the collateral is an important factor in measuring the fair value of the investment or evaluating its carrying amount, it may be necessary for the auditor—in determining whether management has appropriately applied the requirements of the applicable financial reporting framework—to obtain sufficient appropriate audit evidence regarding the existence; value; rights; and access to, or transferability of, such collateral (including consideration of whether all appropriate liens have been filed and appropriate disclosures have been made).

A57. The application of the requirements of the applicable financial reporting framework requires management to consider changes in the environment or circumstances that affect the entity. For example, the introduction of an active market for a particular class of asset or liability may indicate that the use of discounted cash flows to estimate the

13. Paragraph 29 of the clarified SAS *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (Redrafted).
14. See footnote 6.

15. Paragraph 16 of clarified SAS *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*.



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fair value of such asset or liability is no longer appropriate.

Consistency in Methods and Basis for Changes

(Ref: par. 12(b))

A58. The auditor's consideration of a change in an accounting estimate or in the method for making it from the prior period is important because a change that is not based on a change in circumstances or new information is considered arbitrary. Arbitrary changes in an accounting estimate result in inconsistent financial statements over time and may give rise to a financial statement misstatement or be an indicator of possible management bias.

A59. Management often is able to demonstrate good reason for a change in an accounting estimate or the method for making an accounting estimate from one period to another based on a change in circumstances. What constitutes a good reason and the adequacy of support for management's contention that there has been a change in circumstances that warrants a change in an accounting estimate or the method for making an accounting estimate are matters of judgment.

Responses to the Assessed Risks of Material Misstatements

(Ref: par. 13)

A60. The auditor's decision about which response, individually or in combination, identified in paragraph 13 to undertake to respond to the risks of material misstatement may be influenced by such matters as the following:

- The nature of the accounting estimate, including whether it arises from routine or nonroutine transactions
- Whether the procedure(s) is expected to effectively provide the auditor with sufficient appropriate audit evidence
- The assessed risk of material misstatement, including whether the assessed risk is a significant risk

A61. For example, when evaluating the reasonableness of the allowance for doubtful accounts, an effective procedure for the auditor may be to review subsequent cash collections in combination with other procedures. When the estimation uncertainty associated with an accounting estimate is high (for example, an accounting estimate based on a proprietary model for which unobservable inputs exist), it may be that a combination of the responses to assessed risks in paragraph 13 is necessary in order to obtain sufficient appropriate audit evidence.

A62. Additional guidance explaining the circumstances in which each of the responses may be appropriate is provided in paragraphs A63–A101.

Events Occurring Up to the Date of the Auditor's Report

(Ref: par. 13(a))

A63. Determining whether events occurring up to the date of the auditor's report provide audit evidence regarding the accounting estimate may be an appropriate response when such events are expected to

- occur and

- provide audit evidence that confirms or contradicts the accounting estimate.

A64. Events occurring up to the date of the auditor's report may sometimes provide sufficient appropriate audit evidence about an accounting estimate. For example, sale of the complete inventory of a superseded product shortly after the period-end may provide audit evidence relating to the estimate of its net realizable value. In such cases, there may be no need to perform additional audit procedures on the accounting estimate, provided that sufficient appropriate evidence about the events is obtained.

A65. For some accounting estimates, events occurring up to the date of the auditor's report are unlikely to provide audit evidence regarding the accounting estimate. For example, the conditions or events relating to some accounting estimates develop only over an extended period. Also, because of the measurement objective of fair value accounting estimates, information after the period-end may not reflect the events or conditions existing at the balance sheet date and, therefore, may not be relevant to the measurement of the fair value accounting estimate. Paragraph 13 identifies other responses to the risks of material misstatement that the auditor may undertake.

A66. In some cases, events that contradict the accounting estimate may indicate that the amount recorded is misstated, that management has ineffective processes for making accounting estimates, or that management bias exists in the making of accounting estimates.

A67. Even though the auditor may decide not to undertake the approach referred to in paragraph 13(a) with respect to specific accounting estimates, the auditor is required to comply with the clarified SAS *Subsequent Events and Subsequently Discovered Facts*. The auditor is required to perform audit procedures designed to obtain sufficient appropriate audit evidence that all subsequent events that require adjustment of, or disclosure in, the financial statements have been identified.¹⁶ Because the measurement of many accounting estimates, other than fair value accounting estimates, usually depends on the outcome of future conditions, transactions, or events, the auditor's work under the clarified SAS *Subsequent Events and Subsequently Discovered Facts* is particularly relevant.

Testing How Management Made the Accounting Estimate

(Ref: par. 13(b))

A68. Testing how management made the accounting estimate and the data on which it is based may be an appropriate response when the accounting estimate is a fair value accounting estimate developed on a model that uses observable and unobservable inputs. It may also be appropriate when, for example

- the accounting estimate is derived from the routine processing of data by the entity's accounting system.
- the auditor's review of similar accounting esti-

mates made in the prior period financial statements suggests that management's current period process is likely to be effective.

- the accounting estimate is based on a large population of items of a similar nature that individually are not significant.

A69. Testing how management made the accounting estimate and the data on which it is based may involve, for example, the following:

- Testing the extent to which data on which the accounting estimate is based is accurate, complete, and relevant and whether the accounting estimate has been properly determined using such data and management assumptions
- Considering the source, relevance, and reliability of external data or information, including that received from management's specialists,¹⁷ to assist in making an accounting estimate
- Determining how management has taken into account the effect of events, transactions, and changes in circumstances occurring between the date that the estimate or inputs to the estimate were determined and the reporting date, if the estimate was not made as of a date that coincides with the reporting date (for example, a valuation by an independent appraiser may be as of a different date)
- Recalculating the accounting estimate and reviewing, for internal consistency, information used to determine the estimate
- Considering management's review and approval processes

A70. In accordance with the clarified SAS Audit Evidence (Redrafted),¹⁸ the auditor is required to evaluate whether the data on which the estimate is based is sufficiently reliable for the auditor's purposes, including, as necessary

- a. obtaining audit evidence about the accuracy and completeness of the data.
- b. evaluating whether the data is sufficiently precise and detailed for the auditor's purposes.

Considerations Specific to Smaller, Less Complex Entities

A71. In smaller entities, the process for making accounting estimates is likely to be less structured than in larger entities. Smaller entities with active management involvement may have limited descriptions of accounting procedures, unsophisticated accounting records, or few written policies. Even if the entity has no formal established process, management may still be able to provide a basis upon which the auditor can test the accounting estimate.

Evaluating the Method of Measurement

(Ref: par. 13(b)(i))

A72. When the applicable financial reporting framework does not prescribe the method of measurement, evaluating whether the method used

17. Paragraph 5 of clarified SAS Audit Evidence (Redrafted) defines a *management's specialist* as "[a]n individual or organization possessing expertise in a field other than accounting or auditing, whose work in that field is used by the entity to assist the entity in preparing the financial statements."

18. Paragraph 8 of clarified SAS Audit Evidence (Redrafted).

16. Paragraphs 9 and 11 of the clarified SAS *Subsequent Events and Subsequently Discovered Facts*.

(including any applicable model) is appropriate in the circumstances is a matter of professional judgment.

A73. For this purpose, matters that the auditor may consider include, for example, whether

- management's rationale for the method selected is reasonable.
- management sufficiently and appropriately has evaluated and applied the criteria, if any, provided in the applicable financial reporting framework to support the selected method.
- the method is appropriate and sufficient data is available in the circumstances, given the nature of the asset or liability being estimated and the requirements of the applicable financial reporting framework relevant to accounting estimates.
- the method is appropriate in relation to the business, industry, and environment in which the entity operates.

A74. In some cases, management may have determined that different methods result in a range of significantly different estimates. In such cases, obtaining an understanding of how the entity has investigated the reasons for these differences may assist the auditor in evaluating the appropriateness of the method selected.

Evaluating the Use of Models

A75. In some cases, particularly when making fair value accounting estimates, management may use a model. Whether the model used is appropriate in the circumstances may depend on a number of factors, such as the nature of the entity and its environment, including the industry in which it operates and the specific asset or liability being measured.

A76. The extent to which the considerations in paragraph A77 are relevant depends on the circumstances, including whether the model is one that is commercially available for use in a particular sector or industry, or a proprietary model. In some cases, an entity may use a management specialist¹⁹ to develop and test a model.

A77. Depending on the circumstances, matters that the auditor may also consider in testing the model include, for example, whether

- the model is validated prior to usage, with periodic reviews to ensure it is still suitable for its intended use. The entity's validation process may include evaluation of
 - the model's theoretical soundness and mathematical integrity, including the appropriateness of model parameters.
 - the consistency and completeness of the model's inputs with market practices.
 - the model's output compared with actual transactions.
- appropriate change control policies and procedures exist.
- the model is periodically calibrated and tested for validity, particularly when inputs are subjective.
- adjustments are made to the output of the model, including in the case of fair value

accounting estimates whether such adjustments reflect the assumptions that market participants would use in similar circumstances.

- the model is adequately documented, including the model's intended applications and limitations and its key parameters, required inputs, and results of any validation analysis performed.

Assumptions Used by Management (Ref: par. 13(b)(ii))

A78. The auditor's evaluation of the assumptions used by management is based only on information available to the auditor at the time of the audit. Audit procedures dealing with management assumptions, including those used as inputs to valuation models, are performed in the context of the audit of the entity's financial statements and not for the purpose of providing an opinion on assumptions themselves.

A79. Matters that the auditor may consider in evaluating the reasonableness of the assumptions used by management include, for example

- whether individual assumptions appear reasonable.
- whether the assumptions are interdependent and internally consistent.
- whether the assumptions appear reasonable when considered collectively or in conjunction with other assumptions, either for that accounting estimate or for other accounting estimates.
- in the case of fair value accounting estimates, whether the assumptions appropriately reflect observable market assumptions.

A80. In evaluating the reasonableness of the assumptions supporting an accounting estimate, the auditor may identify one or more significant assumptions. If so, the existence of one or more significant assumptions may be an indicator that the accounting estimate has high estimation uncertainty and may, therefore, give rise to a significant risk related to recognition, measurement, or disclosure. Additional responses to significant risks are described in paragraphs A108–A121.

A81. The assumptions on which accounting estimates are based may reflect what management expects will be the outcome of specific objectives and strategies. In such cases, the auditor may perform audit procedures to evaluate the reasonableness of such assumptions by considering, for example, whether the assumptions are consistent with

- the general economic environment and the entity's economic circumstances.
- the plans of the entity.
- assumptions made in prior periods, if relevant.
- the experience of, or previous conditions experienced by, the entity to the extent this historical information may be considered representative of future conditions or events.
- other assumptions used by management relating to the financial statements.

A82. The reasonableness of the assumptions used may depend on management's intent and ability to carry out certain courses of action. Management often documents plans and intentions relevant to specific assets or liabilities, and the financial report-

ing framework may require it to do so. Although the extent of audit evidence to be obtained about management's intent and ability is a matter of professional judgment, the auditor's procedures may include the following:

- Review of management's history of carrying out its stated intentions
- Review of written plans and other documentation, including, when applicable, formally approved budgets, authorizations, or minutes
- Inquiry of management about its reasons for a particular course of action
- Review of events occurring subsequent to the date of the financial statements and up to the date of the auditor's report
- Evaluation of the entity's ability to carry out a particular course of action given the entity's economic circumstances, including the implications of its existing commitments

Certain financial reporting frameworks, however, may not permit management's intentions or plans to be taken into account when making an accounting estimate. This is often the case for fair value accounting estimates because their measurement objective requires that assumptions reflect those used by market participants.

A83. Matters that the auditor may consider in evaluating the reasonableness of assumptions used by management underlying fair value accounting estimates, in addition to those discussed previously, when applicable, may include, for example

- when relevant, whether and, if so, how management has incorporated market-specific inputs into the development of assumptions.
- whether the assumptions are consistent with observable market conditions and the characteristics of the asset or liability being measured at fair value.
- whether the sources of market-participant assumptions are relevant and reliable and how management has selected the assumptions to use when a number of different market participant assumptions exist.
- when appropriate, whether and, if so, how management considered assumptions used in, or information about, comparable transactions, assets, or liabilities.

A84. Further, fair value accounting estimates may comprise observable inputs, as well as unobservable inputs. When fair value accounting estimates are based on unobservable inputs, matters that the auditor may consider include, for example, how management supports

- the identification of the characteristics of market participants relevant to the accounting estimate.
- modifications it has made to its own assumptions to reflect its view of assumptions market participants would use.
- whether it has incorporated appropriate information.
- when applicable, how its assumptions take account of comparable transactions, assets, or liabilities.

If there are unobservable inputs, it is more likely that

19. See footnote 12.

the auditor's evaluation of the assumptions will need to be combined with other responses to assessed risks in paragraph 13 in order to obtain sufficient appropriate audit evidence. In such cases, it may be necessary for the auditor to perform other audit procedures (for example, examining documentation supporting the review and approval of the accounting estimate by appropriate levels of management and, when appropriate, those charged with governance).

A85. Challenges may exist for management when fair value accounting estimates have unobservable inputs, in particular, as a result of illiquid markets. Management may not have the expertise internally to value illiquid or complex financial instruments, and there may be limited sources of information available to establish their values. It may be necessary for management to make assumptions, including assumptions utilized by management based upon the work of a specialist, to develop fair value measurements for illiquid assets.

A86. The reliability of audit evidence is influenced by its source and nature. For example, management may use a broker quote to support a fair value measurement; however, when the quote is obtained from the institution that initially sold the instrument, this evidence may be less objective and may need to be supplemented with evidence from one or more other brokers or information from a pricing service. Pricing services and brokers may use methods of valuation that are not known to management or the auditor. In accordance with paragraph 8(c)(i), the auditor is required to obtain an understanding of how such information was developed. For example, the auditor might inquire whether the value is based on private trades, trades of similar instruments, a cash flow model, or some combination of inputs. Inquiry into the nature of a broker quote is directed at its reliability and consistency with the objective of fair value measurement.

A87. Changes in market conditions may require changes in valuation techniques. Consistency is generally a desirable quality in financial information but may be inappropriate if circumstances change. Paragraph A57 gives the example of the introduction of an active market as an illustration of changed circumstances leading to a move from valuation by model to valuation by market price. In a period of market instability, the changes could be in the opposite direction because markets could become inactive. Even when models have been consistently used, a need for management to examine the continuing appropriateness of the assumptions exists. Further, models may have been calibrated in times when reasonable market information was available but may not provide reasonable valuations in times of unanticipated stress. Consequently, the degree of consistency of valuation techniques and the appropriateness of changes in technique or assumptions require the auditor's attention.

A88. A change in valuation technique does not, however, justify a change in the underlying measurement objective (that is, fair value as defined in the financial reporting framework) to a different standard of value, such as an individual opinion of

value. The clarified *SAS Audit Evidence* (Redrafted) addresses what constitutes audit evidence, the quantity and quality of audit evidence to be obtained, and the audit procedures that the auditor uses for obtaining that audit evidence. Unless management is able to support its valuations, it will be difficult for the auditor to obtain sufficient appropriate audit evidence. However, as evidence about assumptions and the validity of models is necessarily less reliable than evidence of a market price taken from an active market, it may be necessary to look at more sources of evidence to accumulate sufficient appropriate evidence because the audit evidence needed is affected by the risk of misstatement (the greater the risk, the more audit evidence is likely to be required). For example, an auditor or auditor's specialist may use an independent model to compare its results with those of the model used by management in order to evaluate whether the values determined by management's model are reasonable.

A89. In addition, the auditor may consider whether external sources provide audit evidence to which the auditor could benchmark an entity's practices. For example, sources that track losses recorded by institutions may provide the auditor with audit evidence about whether the entity's valuations are reasonable if it has invested in similar instruments as those institutions.

Testing the Operating Effectiveness of Controls (Ref: par. 13(c))

A90. Testing the operating effectiveness of the controls over how management made the accounting estimate may be an appropriate response when management's process has been well-designed, implemented, and maintained. For example

- when controls exist for the review and approval of the accounting estimates by appropriate levels of management and, when appropriate, those charged with governance.
- when the accounting estimate is derived from the routine processing of data by the entity's accounting system.

A91. Testing the operating effectiveness of the controls is required by the clarified *SAS Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (Redrafted)²⁰ when

- a. the auditor's assessment of risks of material misstatement at the relevant assertion level includes an expectation that controls over the process are operating effectively or
- b. substantive procedures alone do not provide sufficient appropriate audit evidence at the relevant assertion level.

Considerations Specific to Smaller, Less Complex Entities

A92. Controls over the process to make an accounting estimate may exist in smaller entities, but the formality with which they operate varies. Further, smaller entities may determine that certain types of

controls are not necessary because of active management involvement in the financial reporting process. In the case of very small entities, however, there may not be many controls that the auditor can identify. For this reason, the auditor's response to the assessed risks is likely to be substantive in nature, with the auditor performing one or more of the other responses identified in paragraph 13.

Developing a Point Estimate or Range (Ref: par. 13(d))

A93. Developing a point estimate or range to evaluate management's point estimate may be an appropriate response when, for example

- an accounting estimate is not derived from the routine processing of data by the accounting system.
- the auditor's review of similar accounting estimates made in the prior period financial statements suggests that management's current period process is unlikely to be effective.
- the entity's controls within and over management's processes for determining accounting estimates are not well-designed or properly implemented.
- events or transactions between the period-end and the date of the auditor's report contradict management's point estimate.
- there are alternative sources of relevant data available to the auditor that can be used in making a point estimate or range.

A94. Even when the entity's controls are well-designed and properly implemented, developing a point estimate or range may be an effective and efficient response to the assessed risks. In other situations, the auditor may consider this approach as part of determining whether further procedures are necessary and, if so, their nature and extent.

A95. The approach taken by the auditor in developing either a point estimate or range may vary based on what is considered most effective in the circumstances. For example, the auditor may initially develop a preliminary point estimate and then assess its sensitivity to changes in assumptions to ascertain a range with which to evaluate management's point estimate. Alternatively, the auditor may begin by developing a range for purposes of determining, when possible, a point estimate.

A96. The ability of the auditor to make a point estimate, as opposed to a range, depends on several factors, including the model used, the nature and extent of data available, and the estimation uncertainty involved with the accounting estimate. Further, the decision to develop a point estimate or range may be influenced by the applicable financial reporting framework, which may prescribe the point estimate that is to be used after consideration of the alternative outcomes and assumptions or prescribe a specific measurement method (for example, the use of a discounted probability-weighted expected value).

A97. The auditor may develop a point estimate or range in a number of ways. For example, by

- using a model (for example, one that is commercially available for use in a particular sector

20. Paragraph 8 of the clarified *SAS Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (Redrafted).

or industry or a proprietary or an auditor-developed model).

- further developing management's consideration of alternative assumptions or outcomes (for example, by introducing a different set of assumptions).
- employing or engaging a person with specialized expertise to develop or execute the model or provide relevant assumptions.
- making reference to other comparable conditions, transactions, or events or, when relevant, markets for comparable assets or liabilities.

Understanding Management's Assumptions or Method (Ref: par. 13(d)(i))

A98. When the auditor makes a point estimate or range and uses assumptions or a method different from those used by management, paragraph 13(d)(i) requires the auditor to obtain a sufficient understanding of the assumptions or method used by management in making the accounting estimate. This understanding provides the auditor with information that may be relevant to the auditor's development of an appropriate point estimate or range. Further, it assists the auditor to understand and evaluate any significant differences from management's point estimate. For example, a difference may arise because the auditor used different, but equally valid, assumptions, compared with those used by management. This may reveal that the accounting estimate is highly sensitive to certain assumptions and, therefore, subject to high estimation uncertainty, indicating that the accounting estimate may be a significant risk. Alternatively, a difference may arise as a result of a factual error made by management. Depending on the circumstances, the auditor may find it helpful in drawing conclusions to discuss with management the basis for the assumptions used and their validity and the difference, if any, in the approach taken to making the accounting estimate.

Narrowing a Range (Ref: par. 13(d)(ii))

A99. When the auditor concludes that it is appropriate to use a range to evaluate the reasonableness of management's point estimate (the auditor's range), paragraph 13(d)(ii) requires that range to encompass all reasonable outcomes, rather than all possible outcomes. The range cannot be one that comprises all possible outcomes if it is to be useful because such a range would be too wide to be effective for purposes of the audit. The auditor's range is useful and effective when it is sufficiently narrow to enable the auditor to conclude whether the accounting estimate is materially misstated.

A100. Ordinarily, a range that has been narrowed to be equal to or less than performance materiality (see the clarified SAS *Materiality in Planning and Performing an Audit*)²¹ is adequate for the purposes of evaluating the reasonableness of management's point estimate. However, particularly in certain industries, it may not be possible to narrow the range to below such an amount. This does not nec-

essarily preclude recognition of the accounting estimate. It may indicate, however, that the estimation uncertainty associated with the accounting estimate is such that it gives rise to a significant risk. Additional responses to significant risks are described in paragraphs A108–A121.

A101. Narrowing the range to a position where all outcomes within the range are considered reasonable may be achieved by

- a. eliminating from the range those outcomes at the extremities of the range judged by the auditor to be unlikely to occur and
- b. continuing to narrow the range, based on audit evidence available, until the auditor concludes that all outcomes within the range are considered reasonable. In some rare cases, the auditor may be able to narrow the range until the audit evidence indicates a point estimate.

Considering Whether Specialized Skills or Knowledge Are Required (Ref: par. 14)

A102. In planning the audit, the auditor is required by the clarified SAS *Planning an Audit*²² to ascertain the nature, timing, and extent of resources necessary to perform the audit engagement. This may include, as necessary, the involvement of those with specialized skills or knowledge. In addition, the clarified SAS *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*²³ requires the engagement partner to be satisfied that the engagement team and any auditor's specialists who are not part of the engagement team collectively have the appropriate competence and capabilities to perform the audit engagement. During the course of the audit of accounting estimates, the auditor may identify, in light of the experience of the auditor and the circumstances of the engagement, the need for specialized skills or knowledge to be applied in relation to one or more aspects of the accounting estimates.

A103. Matters that may affect the auditor's consideration of whether specialized skills or knowledge is required include, for example, the following:

- The nature of the underlying asset, liability, or component of equity in a particular business or industry (for example, mineral deposits, agricultural assets, or complex financial instruments)
- A high degree of estimation uncertainty
- Complex calculations or specialized models are involved (for example, when estimating fair values when no observable market exists)
- The complexity of the requirements of the applicable financial reporting framework relevant to accounting estimates, including whether there are areas known to be subject to differing interpretation or practice is inconsistent or developing
- The procedures that the auditor intends to undertake in responding to assessed risks

A104. For the majority of accounting estimates,

even when estimation uncertainty exists, it is unlikely that specialized skills or knowledge will be required. For example, it is unlikely that specialized skills or knowledge would be necessary for an auditor to evaluate an allowance for doubtful accounts.

A105. However, the auditor may not possess the specialized skills or knowledge required when the matter involved is in a field other than accounting or auditing and may need to obtain it from an auditor's specialist. The proposed SAS *Using the Work of an Auditor's Specialist* addresses determining the need to employ or engage an auditor's specialist and the auditor's responsibilities when using the work of an auditor's specialist.

A106. Further, in some cases, the auditor may conclude that it is necessary to obtain specialized skills or knowledge related to specific areas of accounting or auditing. Individuals with such skills or knowledge may be employed by the auditor's firm or engaged from an external organization outside of the auditor's firm. When such individuals perform audit procedures on the engagement, they are part of the engagement team, and accordingly, they are subject to the requirements in the clarified SAS *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*.

A107. Depending on the auditor's understanding of, and experience working with, the auditor's specialist or those other individuals with specialized skills or knowledge, the auditor may consider it appropriate to discuss matters such as the requirements of the applicable financial reporting framework with the individuals involved to establish that their work is relevant for audit purposes.

Further Substantive Procedures to Respond to Significant Risks (Ref: par. 15–17, 20)

A108. In auditing accounting estimates that give rise to significant risks, the auditor's further substantive procedures are focused on the evaluation of

- a. how management has assessed the effect of estimation uncertainty on the accounting estimate and the effect that such uncertainty may have on the appropriateness of the recognition of the accounting estimate in the financial statements and
- b. the adequacy of related disclosures.

For estimates that give rise to significant risks, the procedures that the auditor is required to perform to address the requirements in paragraphs 12–13 of this SAS may be performed in conjunction with the procedures performed to address the requirements in paragraphs 15–17 of this SAS.

Estimation Uncertainty

Management's Consideration of Estimation Uncertainty (Ref: par. 15(a))

A109. Management may evaluate alternative assumptions or outcomes of the accounting estimates through a number of methods, depending on the circumstances. One possible method used by management is to undertake a sensitivity analysis. This might involve determining how the monetary

22. Paragraph 8 of the clarified SAS *Planning an Audit*.

23. Paragraph 15 of the clarified SAS *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*.

21. Paragraph 10 of the clarified SAS *Materiality in Planning and Performing an Audit*.

amount of an accounting estimate varies with different assumptions. Even for accounting estimates measured at fair value, there can be variation because different market participants will use different assumptions. A sensitivity analysis could lead to the development of a number of outcome scenarios, sometimes characterized as a range of outcomes by management, such as “pessimistic” and “optimistic” scenarios.

A110. A sensitivity analysis may demonstrate that an accounting estimate is not sensitive to changes in particular assumptions. Alternatively, it may demonstrate that the accounting estimate is sensitive to one or more assumptions that then become the focus of the auditor's attention.

A111. This is not intended to suggest that one particular method of addressing estimation uncertainty (such as sensitivity analysis) is more suitable than another or that management's consideration of alternative assumptions or outcomes needs to be conducted through a detailed process supported by extensive documentation. Rather, it is whether management has assessed how estimation uncertainty may affect the accounting estimate that is important, not the specific manner in which it is done. Accordingly, when management has not considered alternative assumptions or outcomes, it may be necessary for the auditor to discuss with management, and request support for how it has addressed, the effects of estimation uncertainty on the accounting estimate.

Considerations Specific to Smaller, Less Complex Entities

A112. Smaller entities may use simple means to assess the estimation uncertainty. In addition to the auditor's review of available documentation, the auditor may obtain other audit evidence of management consideration of alternative assumptions or outcomes by inquiry of management. In addition, management may not have the expertise to consider alternative outcomes or otherwise address the estimation uncertainty of the accounting estimate. In such cases, the auditor may explain to management the process or the different methods available for doing so and the documentation thereof. This would not, however, change the responsibilities of management for the preparation of the financial statements.

Significant Assumptions (Ref: par. 15(b))

A113. An assumption used in making an accounting estimate may be deemed to be significant if a reasonable variation in the assumption would materially affect the measurement of the accounting estimate.

A114. Support for significant assumptions derived from management's knowledge may be obtained from management's continuing processes of strategic analysis and risk management. Even without formal established processes, such as may be the case in smaller entities, the auditor may be able to evaluate the assumptions through inquiries of, and discussions with, management, along with other audit procedures, in order to obtain sufficient appropriate

audit evidence.

A115. The auditor's considerations in evaluating assumptions made by management are described in paragraphs A78–A89.

Management Intent and Ability (Ref: par. 15(c))

A116. The auditor's considerations in relation to assumptions made by management and management's intent and ability are described in paragraphs A12 and A82.

Development of a Range (Ref: par. 16)

A117. In preparing the financial statements, management may be satisfied that it has adequately addressed the effects of estimation uncertainty on the accounting estimates that give rise to significant risks. In some circumstances, however, the auditor may view the efforts of management as inadequate. This may be the case, for example, when, in the auditor's judgment

- sufficient appropriate audit evidence could not be obtained through the auditor's evaluation of how management has addressed the effects of estimation uncertainty.
- it is necessary to explore further the degree of estimation uncertainty associated with an accounting estimate (for example, when the auditor is aware of wide variation in outcomes for similar accounting estimates in similar circumstances).
- it is unlikely that other audit evidence can be obtained (for example, through the review of events occurring up to the date of the auditor's report).
- indicators of management bias in the making of accounting estimates may exist.

A118. The auditor's considerations in determining a range for this purpose are described in paragraphs A93–A101.

Recognition and Measurement Criteria

Recognition of the Accounting Estimates in the Financial Statements (Ref: par. 17(a))

A119. When management has recognized an accounting estimate in the financial statements, the focus of the auditor's evaluation is on whether the measurement of the accounting estimate is sufficiently reliable to meet the recognition criteria of the applicable financial reporting framework.

A120. With respect to accounting estimates that have not been recognized, the focus of the auditor's evaluation is on whether the recognition criteria of the applicable financial reporting framework have, in fact, been met. Even when an accounting estimate has not been recognized and the auditor concludes that this treatment is appropriate, there may be a need for disclosure of the circumstances in the notes to the financial statements. The auditor may also determine that there is a need to draw the reader's attention to a significant uncertainty by adding an emphasis of matter paragraph to the auditor's report. The proposed *SAS Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report* addresses the use of

such paragraphs.

Measurement Basis for the Accounting Estimates (Ref: par. 17(b))

A121. With respect to fair value accounting estimates, some financial reporting frameworks presume that fair value can be measured reliably as a prerequisite to either requiring or permitting fair value measurements and disclosures. In some cases, this presumption may be overcome when, for example, no appropriate method or basis for measurement exists. In such cases, the focus of the auditor's evaluation is on whether management's basis for overcoming the presumption relating to the use of fair value set forth under the applicable financial reporting framework is appropriate.

Evaluating the Reasonableness of the Accounting Estimates and Determining Misstatements (Ref: par. 18)

A122. Based on the audit evidence obtained, the auditor may conclude that the evidence points to an accounting estimate that differs from management's point estimate. When the audit evidence supports a point estimate, the difference between the auditor's point estimate and management's point estimate constitutes a misstatement. When the auditor has concluded that using the auditor's range provides sufficient appropriate audit evidence, a management point estimate that lies outside the auditor's range would not be supported by audit evidence. In such cases, the misstatement is no less than the difference between management's point estimate and the nearest point of the auditor's range.

A123. When management has changed an accounting estimate, or the method in making it, from the prior period based on a subjective assessment that there has been a change in circumstances, the auditor may conclude, based on the audit evidence, that the accounting estimate is misstated as a result of an arbitrary change by management or may regard it as an indicator of possible management bias (see paragraphs A133–A134).

A124. The clarified *SAS Evaluation of Misstatements Identified During the Audit*²⁴ provides guidance on distinguishing misstatements for purposes of the auditor's evaluation of the effect of uncorrected misstatements on the financial statements. In relation to accounting estimates, a misstatement, whether caused by fraud or error, may arise as a result of

- misstatements about which no doubt exists (factual misstatements).
- differences arising from management's judgments concerning accounting estimates that the auditor considers unreasonable or the selection or application of accounting policies that the auditor considers inappropriate (judgmental misstatements).
- the auditor's best estimate of misstatements in populations involving the projection of misstatements identified in audit samples to the entire population from which the samples were

24. Paragraph A3 of the clarified *SAS Evaluation of Misstatements Identified During the Audit*.

drawn (projected misstatements).

In some cases involving accounting estimates, a misstatement could arise as a result of a combination of these circumstances, making separate identification difficult or impossible.

A125. Evaluating the reasonableness of accounting estimates and related disclosures included in the notes to the financial statements, whether required by the applicable financial reporting framework or disclosed voluntarily, involves essentially the same types of considerations applied when auditing an accounting estimate recognized in the financial statements.

Written Representations

A126. Part of the auditor's audit evidence includes obtaining representations from management about whether management believes significant assumptions used in making accounting estimates are reasonable. See the clarified SAS *Written Representations*.²⁵

Communication With Those Charged with Governance

A127. The clarified SAS *The Auditor's Communication With Those Charged With Governance* (Redrafted) addresses the auditor's communications of certain matters related to the conduct of an audit to those charged with governance. The auditor is required by the clarified SAS *The Auditor's Communication With Those Charged With Governance* (Redrafted)²⁶ to communicate the auditor's views about the qualitative aspects of the entity's significant accounting practices, including accounting estimates, and, when applicable, is required to determine that those charged with governance are informed about the process used by management in formulating particularly sensitive accounting estimates and about the basis for the auditor's conclusions regarding the reasonableness of those estimates.

Disclosures Related to Accounting Estimates

Disclosures in Accordance With the Applicable Financial Reporting Framework (Ref: par. 19)

A128. The presentation of financial statements in accordance with the applicable financial reporting framework includes adequate disclosure of material matters. The applicable financial reporting framework may permit or prescribe disclosures related to accounting estimates, and some entities may disclose voluntarily additional information in the notes to the financial statements. These disclosures may include, for example

- the assumptions used.
- the method of estimation used, including any applicable model(s).
- the basis for the selection of the method of estimation.
- the effect of any changes to the method of estimation from the prior period.
- the sources and implications of estimation uncertainty.

Such disclosures are relevant to users in understanding the accounting estimates recognized or disclosed in the financial statements, and sufficient appropriate audit evidence needs to be obtained about whether the disclosures are in accordance with the requirements of the applicable financial reporting framework.

A129. In some cases, the applicable financial reporting framework may require specific disclosures regarding uncertainties. For example, some financial reporting frameworks prescribe the following:

- The disclosure of key assumptions and other sources of estimation uncertainty that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities. Such requirements may be described using terms such as *key sources of estimation uncertainty* or *critical accounting estimates*.
- The disclosure of the range of possible outcomes and the assumptions used in determining the range.
- The disclosure of information regarding the significance of fair value accounting estimates to the entity's financial position and performance.
- Qualitative disclosures, such as the exposures to risk and how they arise; the entity's objectives, policies, and procedures for managing the risk; and the methods used to measure the risk, and any changes from the previous period of these qualitative concepts.
- Quantitative disclosures, such as the extent to which the entity is exposed to risk, based on information provided internally to the entity's key management personnel, including credit risk, liquidity risk, and market risk.

Disclosures of Estimation Uncertainty for Accounting Estimates That Give Rise to Significant Risks (Ref: par. 20)

A130. In relation to accounting estimates having significant risk, even when the disclosures are in accordance with the applicable financial reporting framework, the auditor may conclude that the disclosure of estimation uncertainty is inadequate in light of the circumstances and facts involved. The auditor's evaluation of the adequacy of disclosure of estimation uncertainty increases in importance the greater the range of possible outcomes of the accounting estimate in relation to materiality (see the related discussion in paragraphs A98–A101).

A131. In some cases, the auditor may consider it appropriate to encourage management to describe the circumstances relating to the estimation uncertainty in the notes to the financial statements.

A132. The proposed SAS *Modifications to the Opinion in the Independent Auditor's Report* addresses the implications for the auditor's opinion when the auditor believes that management's disclosure of estimation uncertainty in the financial statements is inadequate or misleading.

Indicators of Possible Management Bias (Ref: par. 21)

A133. During the audit, the auditor may become aware of judgments and decisions made by man-

agement that give rise to indicators of possible management bias (see paragraph A9). Such indicators may affect the auditor's conclusion about whether the auditor's risk assessment and related responses remain appropriate, and the auditor may need to consider the implications for the rest of the audit. Further, they may affect the auditor's evaluation of whether the financial statements as a whole are free from material misstatement, as discussed in the proposed SAS *Forming an Opinion and Reporting on Financial Statements*.

A134. Examples of indicators of possible management bias with respect to accounting estimates include the following:

- Changes in an accounting estimate, or the method for making it, when management has made a subjective assessment that there has been a change in circumstances
- The use of an entity's own assumptions for fair value accounting estimates when they are inconsistent with observable market assumptions
- The selection or construction of significant assumptions that yields a point estimate favorable for management objectives
- The selection of a point estimate that may indicate a pattern of optimism or pessimism

Documentation (Ref: par. 22)

A135. Documentation of indicators of possible management bias identified during the audit assists the auditor in concluding whether the auditor's risk assessment and related responses remain appropriate and in evaluating whether the financial statements as a whole are free from material misstatement. See paragraph A134 for examples of indicators of possible management bias.

A136.

EXHIBIT A: EXAMPLES OF ACCOUNTING ESTIMATES (Ref: par. 2)

The following are examples of accounting estimates that are included in financial statements. The list is presented for information only. It should not be considered all-inclusive.

- **Receivables**
 - Uncollectible receivables
 - Allowance for loan losses
 - Valuation of long-term unconditional promises to give
- **Inventories**
 - Obsolete inventory
 - Net realizable value of inventories when future selling prices and future costs are involved
 - Losses on purchase commitments
- **Financial instruments**
 - Valuation of securities
 - Probability of high correlation of a hedge
 - Sales of securities with puts and calls
- **Productive facilities, natural resources, and intangibles**
 - Useful lives and residual values
 - Depreciation and amortization methods
 - Impairment analysis
 - Recoverability of costs

25. Paragraph 17 of the clarified SAS *Written Representations*.

26. Paragraph 12 of clarified SAS *The Auditor's Communication With Those Charged With Governance* (Redrafted).

- Recoverable reserves
- **Accruals**
 - Property and casualty insurance company loss reserves
 - Compensation in stock option plans and deferred plans
 - Warranty claims
 - Taxes on real and personal property
 - Renegotiation refunds
 - Actuarial assumptions in benefit costs
- **Revenues**
 - Airline passenger revenue
 - Subscription income
 - Freight and cargo revenue
 - Dues income
 - Losses on sales contracts
- **Contracts**
 - Revenue to be earned
 - Costs to be incurred
 - Percent of completion
- **Leases**
 - Initial direct costs
 - Executory costs
 - Residual values
- **Litigation**
 - Probability of loss
 - Amount of loss
- **Rates**
 - Annual effective tax rate in interim reporting
 - Imputed interest rates on receivables and payables
 - Gross profit rates under program method of accounting
- **Other**
 - Losses and net realizable value on disposal of segment or restructuring of a business
 - Fair values in nonmonetary exchanges
 - Interim period costs in interim reporting
 - Current values in personal financial statements

A137.

EXHIBIT B: COMPARISON OF STATEMENT ON AUDITING STANDARDS AUDITING ACCOUNTING ESTIMATES, INCLUDING FAIR VALUE ACCOUNTING ESTIMATES AND RELATED DISCLOSURES WITH INTERNATIONAL STANDARD ON AUDITING 540, AUDITING ACCOUNTING ESTIMATES, INCLUDING FAIR VALUE ACCOUNTING ESTIMATES, AND RELATED DISCLOSURES

This analysis was prepared by the Audit and Attest Standards staff to highlight differences between the Statement on Auditing Standards (SAS) *Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures* and International Standard on Auditing (ISA) 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, and the rationale therefore. This analysis is not authoritative and is prepared for informational purposes only. It has not been acted on or reviewed by the Auditing Standards Board (ASB).

The ASB has made various changes to the language throughout the SAS *Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures*, in comparison with ISA 540. Such changes have been made to use terms applicable in the United States and to make the SAS easier to read and apply. The ASB believes that such changes will not create differences between the application of ISA 540 and the application of the SAS.

Written Representations

Paragraph 22 of ISA 540 requires the auditor to obtain written representations from management and, when appropriate, those charged with governance about whether management and, when appropriate, those charged with governance believe significant assumptions used in making accounting estimates are reasonable. The ASB believes this requirement is more appropriately placed in the clarified SAS *Written Representations*. The placement of this requirement does not create a difference between the ISAs as a whole and auditing standards generally accepted in the United States as a whole.

A138.

CONFORMING AMENDMENT TO STATEMENT ON AUDITING STANDARDS THE AUDITOR'S COMMUNICATION WITH THOSE CHARGED WITH GOVERNANCE (REDRAFTED)

REQUIREMENTS

12. The auditor should communicate with those charged with governance (Ref: par. A23)
- a. the auditor's views about qualitative aspects of the entity's significant accounting practices, including accounting policies, accounting estimates, and financial statement disclosures. When applicable, the auditor should (Ref: par A24–24a)
 - i. explain to those charged with governance why the auditor considers a significant accounting practice that is acceptable under the applicable financial reporting framework not to be most appropriate to the particular circumstances of the entity and
 - ii. determine that those charged with governance are informed about the process used by management in formulating particular-

ly sensitive accounting estimates, including fair value estimates, and about the basis for the auditor's conclusions regarding the reasonableness of those estimates.

APPLICATION MATERIAL

A24. Financial reporting frameworks ordinarily allow for the entity to make accounting estimates and judgments about accounting policies and financial statement disclosures. Open and constructive communication about qualitative aspects of the entity's significant accounting practices may include comment on the acceptability of significant accounting practices. Appendix A identifies matters that may be included in this communication.

A24a. Certain accounting estimates are particularly sensitive because of their significance to the financial statements and because of the possibility that future events affecting them may differ markedly from management's current judgments. In communicating with those charged with governance about the process used by management in formulating particularly sensitive accounting estimates, including fair value estimates, and about the basis for the auditor's conclusions regarding the reasonableness of those estimates, the auditor may consider communicating

- the nature of significant assumptions,
- the degree of subjectivity involved in the development of the assumptions, and
- the relative materiality of the items being measured to the financial statements as a whole.

Statement on Auditing Standards—Audit Evidence—Specific Considerations for Selected Items

Statement on Auditing Standards (SAS) *Audit Evidence—Specific Considerations for Selected Items* supersedes SAS No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments* (AICPA, Professional Standards, vol. 1, AU sec. 337, AU sec. 337A, and AU sec. 337C); SAS No. 1, *Codification of Auditing Standards and Procedures*, section 331, *Inventories* (AICPA, Professional Standards, vol. 1, AU sec. 331); and SAS No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, Professional Standards, vol. 1, AU sec. 332)

The (SAS) *Audit Evidence—Specific Considerations for Selected Items* rescinds SAS No. 12 (AICPA, Professional Standards, vol. 1, AU sec. 337B), and SAS No. 1, section 901, *Public Warehouses—Controls and Auditing Procedures for Goods Held* (AICPA, Professional Standards, vol. 1, AU sec. 901)

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INTRODUCTION

Scope of This Statement on Auditing Standards

1. This Statement on Auditing Standards (SAS) addresses specific considerations by the auditor in obtaining sufficient appropriate audit evidence, in accordance with the clarified SAS *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (Redrafted), the clarified SAS *Audit Evidence* (Redrafted), and other relevant SASs, regarding certain aspects of (a) investments in securities and derivative instruments; (b) inventory; (c) litigation, claims, and assessments involving the entity; and (d) segment information in an audit of financial statements.

Effective Date

2. This SAS is effective for audits of financial statements for periods ending on or after December 15, 2012.

OBJECTIVE

3. The auditor’s objective is to obtain sufficient appropriate audit evidence regarding the

- valuation of investments in securities and derivative instruments;
- existence and condition of inventory;
- completeness of litigation, claims, and assessments involving the entity; and
- presentation and disclosure of segment information, in accordance with the applicable financial reporting framework.

REQUIREMENTS

Investments in Securities and Derivative Instruments (Ref: par. A1–A3)

Investments in Securities When Valuations Are Based on the Investee’s Financial Results

(Excluding Investments Accounted for Using the Equity Method of Accounting)

4. When investments in securities are valued based on an investee’s financial results, excluding investments accounted for using the equity method of accounting, the auditor should obtain sufficient appropriate audit evidence in support of the investee’s financial results, as follows: (Ref: par. A4–A8)

- Obtain and read available financial statements of the investee and the accompanying audit report, if any, including determining whether the report of the other auditor is satisfactory for this purpose.
- If the investee’s financial statements are not audited, or if the audit report on such financial statements is not satisfactory to the auditor, apply, or request that the investor entity arrange with the investee to have another auditor apply, appropriate auditing procedures to such financial statements, considering the materiality of the investment in relation to the financial statements of the investor entity.
- If the carrying amount of the investment reflects factors that are not recognized in the investee’s financial statements or fair values of assets that are materially different from the investee’s carrying amounts, obtain sufficient appropriate audit evidence in support of such amounts.
- If the difference between the financial statement period of the entity and the investee has or could have a material effect on the entity’s financial statements, determine whether the entity’s management has properly considered the lack of comparability and determine the effect, if any, on the auditor’s report. (Ref: par. A9)

If the auditor is not able to obtain sufficient appropriate audit evidence because of an inability to perform one or more of the previous procedures, the auditor should determine the effect on the auditor’s opinion, in accordance with the proposed SAS *Modifications to the Opinion in the Independent Auditor’s Report*.

5. With respect to subsequent events and transactions of the investee occurring after the date of the investee’s financial statements but before the date of the auditor’s report, the auditor should obtain and read available interim financial statements of the investee and make appropriate inquiries of management of the investor to identify such events and transactions that may be material to the investor’s financial statements and that may need to be recognized or disclosed in the investor’s financial statements. (Ref: par. A10)

Investments in Derivative Instruments and Securities Measured or Disclosed at Fair Value

6. With respect to investments in derivative instruments and securities measured or disclosed at fair value, the auditor should

- determine whether the applicable financial reporting framework specifies the method to be used to determine the fair value of the entity’s derivative instruments and investments in securities and
- evaluate whether the determination of fair value

is consistent with the specified valuation method. (Ref: par. A11–A13)

- If estimates of fair value of derivative instruments or securities are obtained from broker-dealers or other third-party sources based on valuation models, the auditor should understand the method used by the broker-dealer or other third-party source in developing the estimate and consider the applicability of the clarified SAS *Audit Evidence* (Redrafted).¹ (Ref: par. A14–A15)
- If derivative instruments or securities are valued by the entity using a valuation model, the auditor should obtain sufficient appropriate audit evidence supporting management’s assertions about fair value determined using the model. (Ref: par. A16)

Impairment Losses

9. The auditor should

- evaluate management’s conclusion (including the relevance of the information considered) about the need to recognize an impairment loss for a decline in a security’s fair value below its cost or carrying amount and
- obtain sufficient appropriate audit evidence supporting the amount of any impairment adjustment recorded, including evaluating whether the requirements of the applicable financial reporting framework have been complied with. (Ref: par. A17–A18)

Unrealized Appreciation or Depreciation

10. The auditor should obtain sufficient appropriate audit evidence about the amount of unrealized appreciation or depreciation in the fair value of a derivative that is recognized or that is disclosed because of the ineffectiveness of a hedge, including evaluating whether the requirements of the applicable financial reporting framework have been complied with. (Ref: par. A19)

Inventory

11. If inventory is material to the financial statements, the auditor should obtain sufficient appropriate audit evidence regarding the existence and condition of inventory² by

- attending physical inventory counting, unless impracticable, to (Ref: par. A20–A22)
 - evaluate management’s instructions and procedures for recording and controlling the results of the entity’s physical inventory counting. (Ref: par. A23)
 - observe the performance of management’s count procedures. (Ref: par. A24)
 - inspect the inventory, and (Ref: par. A25)
 - perform test counts and (Ref: par. A26)
- performing audit procedures over the entity’s

1. See paragraph 8 of the clarified Statement on Auditing Standards (SAS) *Audit Evidence* (Redrafted), which addresses management’s specialists. (See the proposed SAS *Using the Work of an Auditor’s Specialist*, which contains a conforming amendment to the clarified SAS *Audit Evidence* (Redrafted). The purpose of the conforming amendment is to include the requirements and guidance related to management’s specialists in the clarified SAS *Audit Evidence* (Redrafted).)

2. The clarified SAS *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (Redrafted) addresses the auditor’s procedures to respond to the assessed risks of material misstatements at the relevant assertion level.

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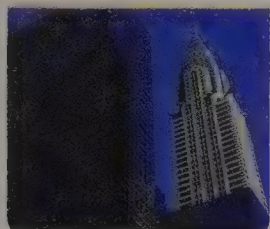
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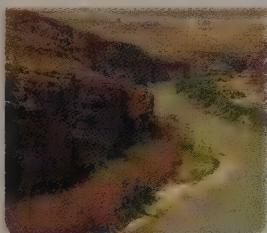
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final inventory records to determine whether they accurately reflect actual inventory count results. (Ref: par. A27–A30)

12. If physical inventory counting is conducted at a date other than the date of the financial statements, the auditor should, in addition to the procedures required by paragraph 11, perform audit procedures to obtain audit evidence about whether changes in inventory between the count date and the date of the financial statements are recorded properly. (Ref: par. A31–A33)

13. If the auditor is unable to attend physical inventory counting due to unforeseen circumstances, the auditor should make or observe some physical counts on an alternative date and perform audit procedures on intervening transactions.

14. If attendance at physical inventory counting is impracticable, the auditor should perform alternative audit procedures to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory. If it is not possible to do so, the auditor should modify the opinion in the auditor's report, in accordance with the proposed SAS *Modifications to the Opinion in the Independent Auditor's Report*. (Ref: par. A34–A36)

15. If inventory under the custody and control of a third party is material to the financial statements, the auditor should obtain sufficient appropriate audit evidence regarding the existence and condition of that inventory by performing one or both of the following:

- a. Request confirmation from the third party regarding the quantities and condition of inventory held on behalf of the entity (Ref: par. A37)
- b. Perform inspection or other audit procedures appropriate in the circumstances (Ref: par. A38)

Litigation, Claims, and Assessments

16. The auditor should design and perform audit procedures to identify litigation, claims, and assessments involving the entity that may give rise to a risk of material misstatement, including (Ref: par. A39–A45)

- a. inquiring of management and, when applicable, others within the entity, including in-house legal counsel;
- b. obtaining from management a description and evaluation of litigation, claims, and assessments that existed at the date of the financial statements being reported on and during the period from the date of the financial statements to the date the information is furnished, including an identification of those matters referred to legal counsel;³
- c. reviewing minutes of meetings of those charged with governance; documents obtained from management concerning litigation, claims, and assessments; and correspondence between the entity and its external legal counsel; and
- d. reviewing legal expense accounts and invoices from the external legal counsel.

17. For actual or potential litigation, claims, and

assessments identified based on the audit procedures required in paragraph 16, the auditor should obtain audit evidence relevant to the following factors:

- a. The period in which the underlying cause for legal action occurred
- b. The degree of probability of an unfavorable outcome
- c. The amount or range of potential loss

Communication With the Entity's Legal Counsel

18. Unless the audit procedures required by paragraph 16 indicate that no actual or potential litigation, claims, or assessments that may give rise to a risk of material misstatement exist, the auditor should, in addition to the procedures required by other SASs, seek direct communication with the entity's external legal counsel. The auditor should do so through a letter of inquiry prepared by management and sent by the auditor requesting the entity's external legal counsel to communicate directly with the auditor. (Ref: par. A40, A46–A63)

19. In addition to the direct communications with the entity's external legal counsel referred to in paragraph 18, the auditor should, in cases when the entity's in-house legal counsel has the responsibility for the entity's litigation, claims, and assessments, seek direct communication with the entity's in-house legal counsel through a letter of inquiry similar to the letter referred to in paragraph 18. Audit evidence obtained from in-house legal counsel in this manner is not, however, a substitute for the auditor seeking direct communication with the entity's external legal counsel, as described in paragraph 18. (Ref: par. A64)

20. The auditor should document the basis for any determination not to seek direct communication with the entity's legal counsel, as required by paragraphs 18–19.

21. The auditor should request management to authorize the entity's legal counsel to discuss applicable matters with the auditor.

22. As described in paragraphs 18–19, the auditor should request, through letter(s) of inquiry, the entity's legal counsel to inform the auditor of any litigation, claims, assessments, and unasserted claims that the counsel is aware of, together with an assessment of the outcome of the litigation, claims, and assessments, and an estimate of the financial implications, including costs involved. Each letter of inquiry should include, but not be limited to, the following matters: (Ref: par. A69)

- a. Identification of the entity, including subsidiaries, and the date of the audit
- b. A list prepared by management (or a request by management that the legal counsel prepare a list) that describes and evaluates pending or threatened litigation, claims, and assessments with respect to which the legal counsel has been engaged and to which the legal counsel has devoted substantive attention on behalf of the company in the form of legal consultation or representation
- c. A list prepared by management that describes and evaluates unasserted claims and assess-

ments that management considers to be probable of assertion and that, if asserted, would have at least a reasonable possibility of an unfavorable outcome with respect to which the legal counsel has been engaged and to which the legal counsel has devoted substantive attention on behalf of the entity in the form of legal consultation or representation

d. Regarding each matter listed in item (b), a request that the legal counsel either provide the following information or comment on those matters on which the legal counsel's views may differ from those stated by management, as appropriate:

- i. A description of the nature of the matter, the progress of the case to date, and the action that the entity intends to take (for example, to contest the matter vigorously or to seek an out-of-court settlement)
- ii. An evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss (Ref: par. A65)
- iii. With respect to a list prepared by management (or by the legal counsel at management's request), an identification of the omission of any pending or threatened litigation, claims, and assessments or a statement that the list of such matters is complete

e. Regarding each matter listed in item (c), a request that the legal counsel comment on those matters on which the legal counsel's views concerning the description or evaluation of the matter may differ from those stated by management

f. A statement that management understands that whenever, in the course of performing legal services for the entity with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, the legal counsel has formed a professional conclusion that the entity should disclose or consider disclosure concerning such possible claim or assessment, the legal counsel, as a matter of professional responsibility to the entity, will so advise the entity and will consult with the entity concerning the question of such disclosure and the requirements of the applicable financial reporting framework (for example, the requirements of Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 450, *Contingencies*)

g. A request that the legal counsel confirm whether the understanding described in item (f) is correct

h. A request that the legal counsel specifically identify the nature of, and reasons for, any limitation on the response

i. A request that the legal counsel specify the effective date of the response

23. When the auditor is aware that an entity has changed legal counsel or that the legal counsel previously engaged by the entity has resigned, the auditor should consider making inquiries of management or others about the reasons such legal counsel is no longer associated with the entity. (Ref: par. A55)

3. For purposes of this SAS, the term *legal counsel* refers to the entity's in-house legal counsel and external legal counsel.

24. The auditor should modify the opinion in the auditor's report, in accordance with the proposed SAS *Forming an Opinion and Reporting on Financial Statements*,⁴ if (Ref: par. A56–A65)

- a. the entity's legal counsel refuses to respond appropriately to the letter of inquiry and the auditor is unable to obtain sufficient appropriate audit evidence by performing alternative audit procedures or
- b. management refuses to give the auditor permission to communicate or meet with the entity's external legal counsel.

Segment Information

25. The auditor should obtain sufficient appropriate audit evidence regarding the presentation and disclosure of segment information, in accordance with the applicable financial reporting framework, by (Ref: par. A66–A67)

- a. obtaining an understanding of the methods used by management in determining segment information and (Ref: par. A68)
 - i. evaluating whether such methods are likely to result in disclosure in accordance with the applicable financial reporting framework and
 - ii. when appropriate, testing the application of such methods and
- b. performing analytical procedures or other audit procedures appropriate in the circumstances.

APPLICATION AND OTHER EXPLANATORY MATERIAL

Investments in Securities and Derivative Instruments (Ref: par. 4–10)

A1. Evaluating audit evidence for assertions about investments in securities and derivative instruments may involve professional judgment because the assertions, especially those about valuation, are based on highly subjective assumptions or are particularly sensitive to changes in the underlying circumstances. Valuation assertions may be based on assumptions about the occurrence of future events for which expectations are difficult to develop or on assumptions about conditions expected to exist over a long period (for example, default rates or prepayment rates). Accordingly, competent persons could reach different conclusions about estimates of fair values or estimates of ranges of fair values. Professional judgment also may be necessary when evaluating audit evidence for assertions based on features of the security or derivative and the requirements of the applicable financial reporting framework, including underlying criteria for hedge accounting, which are extremely complex. For example, determining the fair value of a structured note may require consideration of a variety of features of the note that react differently to changes in economic conditions. In addition, one or more other derivatives may be designated to hedge

changes in cash flows under the note. Evaluating audit evidence about the fair value of the note, the determination of whether the hedge is highly effective, and the allocation of changes in fair value to earnings and other comprehensive income requires professional judgment.

A2. This SAS addresses only certain specific aspects relating to auditing valuation of investments in securities and derivative instruments. The clarified SAS *Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures* addresses the auditor's responsibilities relating to accounting estimates, including fair value accounting estimates and related disclosures in an audit of financial statements. The Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* provides additional and more detailed guidance to auditors related to planning and performing auditing procedures for assertions about derivative instruments, hedging activities, and investments in securities.

Investments in Securities When Valuations Are Based on Cost

A3. Procedures to obtain evidence about the valuation of securities that are recorded at cost may include inspection of documentation of the purchase price, confirmation with the issuer or holder, and testing discount or premium amortization either by recomputation or through the use of analytical procedures.

Investments in Securities When Valuations Are Based on the Investee's Financial Results (Excluding Investments Accounted for Using the Equity Method of Accounting) (Ref: par. 4–5)

A4. The proposed SAS *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)* addresses auditing investments accounted for using the equity method of accounting.

A5. For valuations based on an investee's financial results (excluding investments accounted for using the equity method of accounting), obtaining and reading the financial statements of the investee that have been audited by an auditor whose report is satisfactory may be sufficient for the purpose of obtaining sufficient appropriate audit evidence. In determining whether the report of another auditor is satisfactory, the auditor may perform procedures such as making inquiries regarding the professional reputation and standing of the other auditor, visiting the other auditor, discussing the audit procedures followed and the results thereof, and reviewing the audit plan and audit documentation of the other auditor.

A6. After obtaining and reading the audited financial statements of an investee, the auditor may conclude that additional audit procedures are necessary to obtain sufficient appropriate audit evidence. For example, the auditor may conclude that additional audit evidence is needed because of significant differences in fiscal year-ends, significant differences in accounting principles, changes in ownership, or the significance of the investment to the investor's

financial position or results of operations. Examples of procedures that the auditor may perform are reviewing information in the investor's files that relates to the investee, such as investee minutes and budgets, and investee cash flow information and making inquiries of investor management about the investee's financial results.

A7. The auditor may need to obtain evidence relating to transactions between the entity and investee to evaluate

- a. the propriety of the elimination of unrealized profits and losses on transactions between the entity and investee, if applicable, and
- b. the adequacy of disclosures about material related-party transactions or relationships.

A8. The clarified SAS *Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures* and paragraphs 6–8 of this SAS address auditing fair value accounting estimates. The Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* also provides guidance on audit evidence that may be relevant to the fair value of derivative instruments and securities and on procedures that may be performed by the auditor to evaluate management's consideration of the need to recognize impairment losses.

A9. The date of the investor's financial statements and those of the investee may be different. If the difference between the date of the entity's financial statements and those of the investee has or could have a material effect on the entity's financial statements, the auditor is required, in accordance with paragraph 4(d), to determine whether the entity's management has properly considered the lack of comparability. The effect may be material, for example, because the difference between the financial statement period ends of the entity and investee is not consistent with the prior period in comparative statements or because a significant transaction occurred during the time period between the financial statement period end of the entity and investee. If a change in the difference between the financial statement period end of the entity and investee has a material effect on the investor's financial statements, the auditor may be required, in accordance with the proposed SAS *Consistency of Financial Statements*, to add an emphasis of matter paragraph to the auditor's report because the comparability of financial statements between periods has been materially affected by a change in reporting period.

A10. The clarified SAS *Subsequent Events and Subsequently Discovered Facts* addresses the auditor's responsibilities relating to subsequent events and subsequently discovered facts in an audit of financial statements.

Investments in Derivative Instruments and Securities Measured or Disclosed at Fair Value (Ref: par. 6–8)

A11. The method for determining fair value may be specified by the applicable financial reporting framework and may vary depending on the industry in which the entity operates or the nature of the entity. Such differences may relate to the consideration of price quotations from inactive markets and significant liquidity discounts, control premiums,

4. Paragraph 21 of the proposed SAS *Forming an Opinion and Reporting on Financial Statements*.

and commissions and other costs that would be incurred to dispose of the derivative instrument or security.

A12. If the determination of fair value requires the use of accounting estimates, see the clarified SAS *Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures*, which addresses auditing fair value accounting estimates, including requirements and guidance relating to the auditor's understanding of the applicable financial reporting framework relevant to accounting estimates and the method used in making the estimate⁵ and the auditor's determination of whether management has appropriately applied the requirements of the applicable financial reporting framework relevant to the accounting estimate.⁶ The Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* also provides guidance on audit evidence that may be relevant to the fair value of derivative instruments and investments in securities.

A13. Quoted market prices for derivative instruments and securities listed on national exchanges or over-the-counter markets are available from sources such as financial publications, the exchanges, NASDAQ, or pricing services based on sources such as those. Quoted market prices obtained from those sources generally provide sufficient evidence of the fair value of the derivative instruments and securities.

A14. For certain other derivative instruments and securities, quoted market prices may be obtained from broker-dealers who are market makers in them or through the National Quotation Bureau. However, using such a price quote to test valuation assertions may require special knowledge to understand the circumstances in which the quote was developed. For example, quotations published by the National Quotation Bureau may not be based on recent trades and may be only an indication of interest and not an actual price for which a counterparty will purchase or sell the underlying derivative instrument or security.

A15. If quoted market prices are not available for the derivative instrument or security, estimates of fair value frequently may be obtained from broker-dealers or other third-party sources, based on proprietary valuation models, or from the entity, based on internally or externally developed valuation models (for example, the Black-Scholes option pricing model). Understanding the method used by the broker-dealer or other third-party source in developing the estimate may include, for example, understanding whether a pricing model or cash flow projection was used. The auditor also may determine that it is necessary to obtain estimates from more than one pricing source. For example, this may be appropriate if either of the following occurs:

- The pricing source has a relationship with an

entity that might impair its objectivity, such as an affiliate or a counterparty involved in selling or structuring the product.

- The valuation is based on assumptions that are highly subjective or particularly sensitive to changes in the underlying circumstances.

See also the clarified SAS *Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures*.⁷

A16. Examples of valuation models include the present value of expected future cash flows, option-pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis. Refer to the clarified SAS *Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures* for the auditor's procedures to obtain evidence supporting management's assertions about fair value that are determined using a valuation model.

Impairment Losses (Ref: par. 9)

A17. Regardless of the valuation method used, the applicable financial reporting framework might require recognizing, in earnings or other comprehensive income, an impairment loss for a decline in fair value that is other than temporary. Determinations of whether losses are other than temporary may involve estimating the outcome of future events and making judgments in determining whether factors exist that indicate that an impairment loss has been incurred at the end of the reporting period. These judgments are based on subjective as well as objective factors, including knowledge and experience about past and current events and assumptions about future events. The following are examples of such factors:

- Fair value is significantly below cost or carrying value and
 - the decline is attributable to adverse conditions specifically related to the security or specific conditions in an industry or a geographic area.
 - the decline has existed for an extended period of time.
 - for an equity security, management has the intent to sell the security or it is more likely than not that it will be required to sell the security before recovery.
 - for a debt security, management has the intent to sell the security or it is more likely than not it will be required to sell the security before the security's anticipated recovery of its amortized cost basis (for example, if the entity's cash or working capital requirements or contractual or regulatory obligations indicate that the debt security will be required to be sold before the forecasted recovery occurs).
- The security has been downgraded by a rating agency.
- The financial condition of the issuer has deteriorated.

- Dividends have been reduced or eliminated or scheduled interest payments have not been made.
- The entity recorded losses from the security subsequent to the end of the reporting period.

A18. Evaluating the relevance of the information considered may include obtaining evidence about factors such as those referred to in paragraph A17 that tend to corroborate or conflict with management's conclusions.

Unrealized Appreciation or Depreciation (Ref: par. 10)

A19. Obtaining audit evidence about the amount of unrealized appreciation or depreciation in the fair value of a derivative that is recognized or that is disclosed because of the ineffectiveness of a hedge may include understanding the methods used to determine whether the hedge is highly effective and to determine the ineffective portion of the hedge.

Inventory

Attendance at Physical Inventory Counting (Ref: par. 11(a))

A20. Management ordinarily establishes procedures under which inventory is physically counted at least once per year to serve as a basis for the preparation of the financial statements and, if applicable, to ascertain the reliability of the entity's perpetual inventory system.

A21. Attendance at physical inventory counting involves

- inspecting the inventory to ascertain its existence and evaluate its condition and performing test counts,
- observing compliance with management's instructions and the performance of procedures for recording and controlling the results of the physical inventory count, and
- obtaining audit evidence about the reliability of management's count procedures.

These procedures may serve as tests of controls or substantive procedures, or both, depending on the auditor's risk assessment, planned approach, and the specific procedures carried out.

A22. Matters relevant in planning attendance at physical inventory counting (or in designing and performing audit procedures pursuant to paragraphs 11–15 of this SAS) include, for example, the following:

- The risks of material misstatement related to inventory.
- The control risk related to inventory.
- Whether adequate procedures are expected to be established and proper instructions issued for physical inventory counting.
- The timing of physical inventory counting.
- Whether the entity maintains a perpetual inventory system.
- The locations at which inventory is held, including the materiality of the inventory and the risks of material misstatement at different locations, in deciding at which locations attendance is appropriate. The proposed SAS *Special Considerations*—

5. Paragraphs 8(a), 8(c), A12–A14, and A23–A25 of the clarified SAS *Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures*.

6. Paragraphs 12(a) and A53–A57 of the clarified SAS *Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures*.

7. Paragraphs A68–A89 of the clarified SAS *Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures*.

Audits of Group Financial Statements (Including the Work of Component Auditors) addresses the involvement of component auditors and, accordingly, may be relevant if such involvement is with regard to attendance of physical inventory counting at a remote location.

- Whether the assistance of an auditor's specialist is needed. The proposed *SAS Using the Work of an Auditor's Specialist* addresses the use of an auditor's specialist to assist the auditor in obtaining sufficient appropriate audit evidence.

Evaluate Management's Instructions and Procedures (Ref: par. 11(a)(i))

A23. Matters relevant in evaluating management's instructions and procedures for recording and controlling the physical inventory counting include whether they address, for example, the following:

- The application of appropriate control activities (for example, the collection of used physical inventory count records, accounting for unused physical inventory count records, and count and recount procedures)
- The accurate identification of the stage of completion of work in progress; slow moving, obsolete, or damaged items; and inventory owned by a third party (for example, on consignment)
- The procedures used to estimate physical quantities, when applicable, such as may be needed in estimating the physical quantity of a coal pile
- Control over the movement of inventory between areas and the shipping and receipt of inventory before and after the cutoff date

Observe the Performance of Management's Count Procedures (Ref: par. 11(a)(ii))

A24. Observing the performance of management's count procedures (for example, those relating to control over the movement of inventory before, during, and after the count) assists the auditor in obtaining audit evidence that management's instructions and count procedures are designed and implemented adequately. In addition, the auditor may obtain copies of cutoff information, such as details of the movement of inventory, to assist the auditor in performing audit procedures over the accounting for such movements at a later date.

Inspect the Inventory (Ref: par. 11(a)(iii))

A25. Inspecting inventory when attending physical inventory counting assists the auditor in ascertaining the existence of the inventory (though not necessarily its ownership) and in identifying obsolete, damaged, or aging inventory.

Perform Test Counts (Ref: par. 11(a)(iv))

A26. Performing test counts (for example, by tracing items selected from management's count records to the physical inventory and tracing items selected from the physical inventory to management's count records) provides audit evidence about the completeness and accuracy of those records.

A27. In addition to recording the auditor's test counts, obtaining copies of management's completed physical inventory count records assists the

auditor in performing subsequent audit procedures to determine whether the entity's final inventory records accurately reflect actual inventory count results.

Use of Management's Specialists

A28. Management may engage specialists who have expertise in the taking of physical inventories to count, list, price, and subsequently compute the total dollar amount of inventory on hand at the date of the physical count. For example, entities such as retail stores, hospitals, and automobile dealers may use specialists in this manner.

A29. An inventory count performed by an external inventory firm engaged as a management specialist does not, by itself, provide the auditor with sufficient appropriate audit evidence. The auditor is required by the clarified *SAS Audit Evidence* (Redrafted)⁸ to perform certain procedures if information to be used as audit evidence has been prepared using the work of a management's specialist. The auditor may, for example, examine the specialist's program, observe its procedures and controls, make or observe some physical counts of the inventory, recompute calculations of the submitted inventory on a test basis, and apply appropriate tests to the intervening transactions.

A30. Although the auditor may adjust the extent of the work on the physical count of inventory because of the work of management's specialist, any restriction imposed on the auditor such that the auditor is unable to perform the procedures that the auditor considers necessary is a scope limitation. In such cases, the proposed *SAS Modifications to the Opinion in the Independent Auditor's Report* requires the auditor to modify the opinion in the auditor's report as a result of the scope limitation.

Physical Inventory Counting Conducted Other Than at the Date of the Financial Statements (Ref: par. 12)

A31. For practical reasons, the physical inventory counting may be conducted at a date, or dates, other than the date of the financial statements. This may be done irrespective of whether management determines inventory quantities by an annual physical inventory counting or maintains a perpetual inventory system. In either case, the effectiveness of the design, implementation, and maintenance of controls over changes in inventory determines whether the conduct of physical inventory counting at a date (or dates) other than the date of the financial statements is appropriate for audit purposes. The clarified *SAS Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (Redrafted) addresses substantive procedures performed at an interim date.

A32. When a perpetual inventory system is maintained, management may perform physical counts or other tests to ascertain the reliability of inventory quantity information included in the entity's perpetual inventory records. In some cases, management or the auditor may identify differences between the

perpetual inventory records and actual physical inventory quantities on hand; this may indicate that the controls over changes in inventory are not operating effectively.

A33. Relevant matters for consideration when designing audit procedures to obtain audit evidence about whether changes in inventory amounts between the count date, or dates, and the final inventory records are recorded properly include the following:

- Whether the perpetual inventory records are properly adjusted
- Reliability of the entity's perpetual inventory records
- Reasons for significant differences between the information obtained during the physical count and the perpetual inventory records

Attendance at Physical Inventory Counting Is Impracticable (Ref: par. 14)

A34. In some cases, attendance at physical inventory counting may be impracticable. This may be due to factors such as the nature and location of the inventory (for example, when inventory is held in a location that may pose threats to the safety of the auditor). The matter of general inconvenience to the auditor, however, is not sufficient to support a decision by the auditor that attendance is impracticable. Further, as explained in the clarified *SAS Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*, the matter of difficulty, time, or cost involved is not, in itself, a valid basis for the auditor to omit an audit procedure for which no alternative exists or to be satisfied with audit evidence that is less than persuasive.

A35. In some cases, when attendance is impracticable, alternative audit procedures (for example, observing a current physical inventory count and reconciling it to the opening inventory quantities or inspection of documentation of the subsequent sale of specific inventory items acquired or purchased prior to the physical inventory counting) may provide sufficient appropriate audit evidence about the existence and condition of inventory. If the audit covers the current period and one or more periods for which the auditor had not observed or made some physical counts of prior inventories, alternative audit procedures, such as tests of prior transactions or reviews of the records of prior counts, may provide sufficient appropriate audit evidence about the prior inventories. The effectiveness of the alternative procedures that an auditor may perform is affected by the length of the period that the alternative procedures cover.

A36. In other cases, however, it may not be possible to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by performing alternative audit procedures. In such cases, the proposed *SAS Modifications to the Opinion in the Independent Auditor's Report* requires the auditor to modify the opinion in the auditor's report as a result of the scope limitation. In addition, the clarified *SAS Opening Balances—Initial Audit Engagements, Including Reaudit Engagements* addresses the

8. See footnote 2.

auditor's procedures regarding inventory opening balances in initial audit engagements.⁹

Inventory Under the Custody and Control of a Third Party

Confirmation (Ref: par. 15(a))

A37. The clarified SAS *External Confirmations* addresses external confirmation procedures.

Other Audit Procedures (Ref: par. 15(b))

A38. Depending on the circumstances (for example, when information is obtained that raises doubt about the integrity and objectivity of the third party), the auditor may consider it appropriate to perform other audit procedures instead of, or in addition to, confirmation with the third party. Examples of other audit procedures include the following:

- Attending, or arranging for another auditor to attend, the third party's physical counting of inventory, if practicable
- Obtaining another auditor's report on the adequacy of the third party's internal control for ensuring that inventory is properly counted and adequately safeguarded
- Inspecting documentation regarding inventory held by third parties (for example, warehouse receipts)
- Requesting confirmation from other parties when inventory has been pledged as collateral

Litigation, Claims, and Assessments

Completeness of Litigation, Claims, and Assessments (Ref: par. 16)

A39. Litigation, claims, and assessments involving the entity may have a material effect on the financial statements and, thus, may be required to be recognized, measured, or disclosed in the financial statements.

A40. Other legal matters involving the entity may not have a material effect on the entity's financial statements and, accordingly, would not give rise to risks of material misstatement. Examples of such other legal matters may be

- matters unrelated to actual or potential litigation, claims, or assessments, such as consulting services related to real estate or potential merger and acquisition transactions;
- matters in which the entity records indicate that management or the legal counsel has not devoted substantive attention to the matter;
- matters in which the entity's insurance coverage exceeds the amount of the actual or potential litigation, claim, or assessment sought against the entity; or
- matters that are clearly trivial to the financial statements.

A41. Management is responsible for adopting policies and procedures to identify, evaluate, and account for litigation, claims, and assessments as a

basis for the preparation of financial statements, in accordance with the requirements of the applicable financial reporting framework.

A42. Management is the primary source of information about events or conditions considered in the financial accounting for, and reporting of, litigation, claims, and assessments because these matters are within the direct knowledge and, often, control of management. Accordingly, the auditor's procedures with respect to litigation, claims, and assessments include the following:

- Making inquiries of management as required by paragraph 16(a), which may include a discussion about the policies and procedures adopted for identifying, evaluating, and accounting for litigation, claims, and assessments involving the entity that may give rise to a risk of material misstatement
- Obtaining written representations from management, in accordance with the clarified SAS *Written Representations*,¹⁰ that all known actual or possible litigation, claims, and assessments whose effects should be considered when preparing the financial statements have been disclosed to the auditor and accounted for and disclosed in accordance with the applicable financial reporting framework

A43. In addition to the procedures identified in paragraph 16, other relevant procedures include, for example, using information obtained through risk assessment procedures carried out as part of obtaining an understanding of the entity and its environment to assist the auditor to become aware of litigation, claims, and assessments involving the entity. Examples of such procedures are as follows:

- Reading minutes of meetings of stockholders; directors; governing bodies of governmental entities; and appropriate committees held during, and subsequent to, the period being audited
- Reading contracts, loan agreements, leases, correspondence from taxing or other governmental agencies, and similar documents
- Obtaining information concerning guarantees from bank confirmation forms
- Inspecting other documents for possible guarantees by the entity

The clarified SAS *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (Redrafted) addresses the auditor's requirement to obtain an understanding of the entity and its environment.¹¹ In addition, the clarified SAS *Consideration of Laws and Regulations in an Audit of Financial Statements* addresses the auditor's requirement to obtain an understanding of the entity's legal and regulatory framework applicable to the entity and industry or sector in which the entity operates and how the entity is complying with that framework.

A44. Audit evidence obtained for purposes of identifying litigation, claims, and assessments that may give rise to a risk of material misstatement also may provide audit evidence regarding other relevant con-

siderations, such as valuation or measurement, regarding litigation, claims, and assessments. The clarified SAS *Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures* addresses the auditor's consideration of litigation, claims, and assessments requiring accounting estimates or related disclosures in the financial statements.

A45. This SAS addresses inquiries of the entity's legal counsel with whom management has consulted. If management has not consulted legal counsel, the auditor would rely on the procedures required by paragraph 16 to identify litigation, claims, and assessments involving the entity, which may give rise to a risk of material misstatement, and the written representation of management regarding litigation, claims, and assessments, as required by the clarified SAS *Written Representations*.

Communication With the Entity's Legal Counsel (Ref: par. 18–24)

A46. An auditor ordinarily does not possess legal skills and, therefore, cannot make legal judgments concerning information coming to the auditor's attention.

A47. Direct communication with the entity's legal counsel assists the auditor in obtaining sufficient appropriate audit evidence about whether potentially material litigation, claims, and assessments are known and management's estimates of the financial implications, including costs, are reasonable.

A48. The American Bar Association (ABA) has approved *Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information* (the ABA statement), which explains the concerns of the legal counsel and the nature of the limitations that an auditor is likely to encounter in connection with seeking direct communication with the entity's legal counsel about litigation, claims, assessments, and unasserted claims.¹²

A49. A letter of inquiry to the entity's legal counsel is the auditor's primary means of obtaining corroboration of the information provided by management concerning material litigation, claims, and assessments. Audit evidence obtained from the entity's in-house general counsel or legal department may provide the auditor with the necessary corroboration.

A50. In certain circumstances, the auditor also may judge it necessary to meet with the entity's legal counsel to discuss the likely outcome of the litigation or claims. This may be the case, for example, when

- the auditor determines that the matter is a significant risk.
- the matter is complex.
- a disagreement exists between management and the entity's external legal counsel.

Ordinarily, such meetings require management's permission and are held with a representative of management in attendance.

9. Paragraph A11 of the clarified SAS *Opening Balances—Initial Audit Engagements, Including Reaudit Engagements*.

10. Paragraph 15 of the clarified SAS *Written Representations*.

11. Paragraph 12 of the clarified SAS *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (Redrafted).

12. The *Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information* is reprinted as exhibit A, "American Bar Association Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information," for the convenience of readers but is not an integral part of this SAS.

A51. An external legal counsel's response to a letter of inquiry and the procedures set forth in paragraphs 16–17 provide the auditor with sufficient appropriate audit evidence concerning the accounting for, and reporting of, pending and threatened litigation, claims, and assessments.

A52. In accordance with the proposed SAS *Forming an Opinion and Reporting on Financial Statements*, the auditor is required to date the auditor's report no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements. Audit evidence about the status of litigation, claims, and assessments up to the date of the auditor's report may be obtained by inquiry of management, including in-house legal counsel responsible for dealing with the relevant matters. The auditor may need to obtain updated information from the entity's legal counsel.

A53. Because the auditor's report should be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements,¹³ it is preferable that the entity's legal counsel's response be as close to the date of the auditor's report as is practicable in the circumstances. Specifying the effective date of the entity's legal counsel's response to reasonably approximate the expected date of the auditor's report may obviate the need to obtain updated information from the entity's legal counsel.

A54. Clearly specifying the earliest acceptable effective date of the response and the latest date by which it is to be sent to the auditor and informing the entity's legal counsel of these dates timely facilitates the entity's legal counsel's ability to respond timely and adequately. A two-week period between the specified effective date of the entity's legal counsel's response and the latest date by which the response is to be sent to the auditor is generally sufficient.

A55. In some circumstances, the legal counsel may be required by relevant ethical requirements to resign the engagement if the legal counsel's advice concerning financial accounting and reporting for litigation, claims, and assessments is disregarded by the entity.

A56. The legal counsel appropriately may limit the response to matters to which the legal counsel has given substantive attention in the form of legal consultation or representation. Also, the legal counsel's response may be limited to matters that are considered individually or collectively material to the financial statements, such as when the entity and auditor have reached an understanding on the limits of materiality for this purpose and management has communicated such understanding to the legal counsel. Such limitations are not limitations on the scope of the audit.

A57. The legal counsel may be unable to respond concerning the likelihood of an unfavorable outcome of litigation, claims, and assessments or the amount or range of potential loss because of inher-

ent uncertainties. Factors influencing the likelihood of an unfavorable outcome sometimes may not be within the legal counsel's competence to judge; historical experience of the entity in similar litigation or the experience of other entities may not be relevant or available, and the amount of the possible loss frequently may vary widely at different stages of litigation. Consequently, the legal counsel may not be able to form a conclusion with respect to such matters. In such circumstances, the auditor may conclude that the financial statements are affected by an uncertainty concerning the outcome of a future event that cannot be reasonably estimated. If the auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement, the proposed SAS *Modifications to the Opinion in the Independent Auditor's Report* requires the auditor to modify the opinion in addressing the effect, if any, of the legal counsel's response on the auditor's report as a result of the scope limitation.¹⁴

A58. An external legal counsel's refusal to furnish the information requested in an inquiry letter either in writing or orally may cause a scope limitation of the audit sufficient to preclude an unqualified opinion.

A59. Although the auditor would consider the inability to review information that could have a significant bearing on the audit as a scope limitation, in recognition of the public interest in protecting the confidentiality of lawyer-client communications, such inability is not intended to require an auditor to examine documents that the client identifies as subject to the lawyer-client privilege. In the event of questions concerning the applicability of this privilege, the auditor may request confirmation from the entity's legal counsel that the information is subject to that privilege and that the information was considered by the legal counsel in responding to the letter of inquiry or, if the matters are being handled by another legal counsel, an identification of such legal counsel for the purpose of sending a letter of inquiry.

A60. If management imposes a limitation on the scope of the audit and the auditor is unable to obtain sufficient appropriate audit evidence by performing alternative audit procedures, the auditor is required by the proposed SAS *Modifications to the Opinion in the Independent Auditor's Report* to either disclaim an opinion on the financial statements or, when practicable, withdraw from the audit.¹⁵

A61. In some cases, in order to emphasize the preservation of the attorney-client privilege or the attorney work-product privilege, some entities may include the following or substantially similar language in the audit inquiry letter to legal counsel:

We do not intend that either our request to you to provide information to our auditor or your response to our auditor should be construed in any way to constitute a waiver of the attorney-client privilege or the attorney work-product

privilege.

For the same reason, some legal counsel may include the following or substantially similar language in their response letters to auditors:

The Company [OR OTHER DEFINED TERM] has advised us that, by making the request set forth in its letter to us, the Company [OR OTHER DEFINED TERM] does not intend to waive the attorney-client privilege with respect to any information which the Company [OR OTHER DEFINED TERM] has furnished to us. Moreover, please be advised that our response to you should not be construed in any way to constitute a waiver of the protection of the attorney work-product privilege with respect to any of our files involving the Company [OR OTHER DEFINED TERM].

Explanatory language similar to the foregoing in the letters of the entity or legal counsel is not a limitation on the scope of the legal counsel's response. See Exhibit B, "Report of the Subcommittee on Audit Inquiry Responses."

A62. In order to emphasize the preservation of the attorney-client privilege with respect to unasserted possible claims or assessments, some legal counsel may include the following or substantially similar language in their responses to audit inquiry letters:

Please be advised that pursuant to clauses (b) and (c) of Paragraph 5 of the ABA Statement of Policy [American Bar Association's Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information] and related Commentary referred to in the last paragraph of this letter, it would be inappropriate for this firm to respond to a general inquiry relating to the existence of unasserted possible claims or assessments involving the Company. We can only furnish information concerning those unasserted possible claims or assessments upon which the Company has specifically requested in writing that we comment. We also cannot comment upon the adequacy of the Company's listing, if any, of unasserted possible claims or assessments or its assertions concerning the advice, if any, about the need to disclose same.

Additional language similar to the foregoing in a letter from legal counsel is not a limitation on the scope of the audit. However, the ABA statement and the understanding between the legal and accounting professions assumes that the legal counsel, under certain circumstances, will advise and consult with the entity concerning the entity's obligation to make financial statement disclosure with respect to unasserted possible claims or assessments. Confirmation of this understanding is included in the legal counsel's response.

A63. If the auditor believes that there may be actual or potential material litigation, claims, or assessments and the entity has not engaged external legal counsel relating to such matters, the auditor may discuss with the client the possible need to consult legal counsel to assist the client in determining the appropriate measurement, recognition, or disclosure of related liabilities or loss contingencies in the financial statements, in accordance with the

13. Paragraph 39 of the proposed SAS *Forming an Opinion and Reporting on Financial Statements*.

14. Paragraph 7 of the proposed SAS *Modifications to the Opinion in the Independent Auditor's Report*.

15. Paragraph 13 of the proposed SAS *Modifications to the Opinion in the Independent Auditor's Report*.

applicable financial reporting framework. Depending on the significance of the matter(s), refusal by management to consult legal counsel in these circumstances may result in a scope limitation of the audit sufficient to preclude an unqualified opinion.

Direct Communication With the Entity's In-House Legal Counsel

A64. In-house legal counsel can range from one lawyer to a large staff, with responsibilities ranging from specific internal matters to a comprehensive coverage of all of the entity's legal needs, including litigation with outside parties. Because both in-house and external legal counsel are bound by an applicable code of ethics, there should be no significant difference in their professional obligations and responsibilities. In some circumstances, external legal counsel, if used at all, may be used only for limited purposes, such as data accumulation or account collection activity. In such circumstances, in-house legal counsel may have the primary responsibility for corporate legal matters and may be in the best position to know and precisely describe the status of all litigation, claims, and assessments or to corroborate information provided by management.

Evaluation of the Outcome of Litigation, Claims, or Assessment (Ref: par. 22(d)(ii))

A65. Although paragraph 5 of the ABA statement states that the legal counsel "may in appropriate circumstances communicate to the auditor his view that an unfavorable outcome is 'probable' or 'remote,'" the legal counsel is not required to use those terms in communicating the evaluation to the auditor. The auditor may find other wording sufficiently clear, as long as the terms can be used to classify the outcome of the uncertainty under one of the three probability classifications established in FASB ASC 450. Some examples of evaluations concerning litigation that may be considered to provide sufficient clarity that the likelihood of an unfavorable outcome is remote, even though they do not use that term, are the following:

- "We are of the opinion that this action will not result in any liability to the company."
- "It is our opinion that the possible liability to the company in this proceeding is nominal in amount."
- "We believe the company will be able to defend this action successfully."
- "We believe that the plaintiff's case against the company is without merit."
- "Based on the facts known to us, after a full investigation, it is our opinion that no liability will be established against the company in these suits."

Absent any contradictory information obtained by the auditor either in other parts of the legal counsel's letter or otherwise, the auditor need not obtain further clarification of evaluations such as the foregoing. Because of inherent uncertainties described in paragraph A57 and the ABA statement, an evaluation furnished by the legal counsel may indicate significant uncertainties or stipulations about

whether the client will prevail. The following are examples of the legal counsel's evaluations that are unclear about the likelihood of an unfavorable outcome:

- "This action involves unique characteristics wherein authoritative legal precedents do not seem to exist. We believe that the plaintiff will have serious problems establishing the company's liability under the act; nevertheless, if the plaintiff is successful, the award may be substantial."
- "It is our opinion that the company will be able to assert meritorious defenses to this action." (The term *meritorious defenses* indicates that the entity's defenses will not be summarily dismissed by the court; it does not necessarily indicate the legal counsel's opinion that the entity will prevail.)
- "We believe the action can be settled for less than the damages claimed."
- "We are unable to express an opinion as to the merits of the litigation at this time. The company believes there is absolutely no merit to the litigation." (If the entity's legal counsel, with the benefit of all relevant information, is unable to conclude that the likelihood of an unfavorable outcome is remote, it is unlikely that management would be able to form a judgment to that effect.)
- "In our opinion, the company has a substantial chance of prevailing in this action." (A *substantial chance*, a *reasonable opportunity*, and similar terms indicate more uncertainty than an opinion that the company will prevail.)

If the auditor is uncertain about the meaning of the legal counsel's evaluation, clarification either in a follow-up letter or conference with the legal counsel and entity, appropriately documented, may be appropriate. If the legal counsel is still unable to give an unequivocal evaluation of the likelihood of an unfavorable outcome in writing or orally, the auditor is required by the proposed SAS *Forming an Opinion and Reporting on Financial Statements* to determine the effect, if any, of the legal counsel's response on the auditor's report.

Segment Information (Ref: par. 25)

A66. Depending on the applicable financial reporting framework, the entity may be required or permitted to disclose segment information in the financial statements. The auditor's responsibility regarding the presentation and disclosure of segment information is in relation to the financial statements as a whole. Accordingly, the auditor is not required to perform audit procedures that would be necessary to express an opinion on the segment information presented on a stand-alone basis.

Considerations Specific to Governmental Entities

A67. For governmental entities required by the applicable financial reporting framework to disclose segment information, the auditor's responsibility regarding the presentation and disclosure of segment information is in relation to the financial state-

ments of the opinion unit(s) on which the segment information is based.¹⁶

Understanding of the Methods Used by Management (Ref: par. 25(a))

A68. Depending on the circumstances, examples of matters that may be relevant when obtaining an understanding of the methods used by management in determining segment information and evaluating whether such methods are likely to result in disclosure in accordance with the applicable financial reporting framework include the following:

- Sales, transfers, and charges between segments and elimination of intersegment amounts
- Comparisons with budgets and other expected results (for example, operating profits as a percentage of sales)
- The allocation of assets and costs among segments
- Consistency with prior periods and the adequacy of the disclosures with respect to inconsistencies
- Management's process for identifying those segments that require disclosure in accordance with the entity's financial reporting framework

A69.

APPENDIX A: ILLUSTRATIVE AUDIT INQUIRY LETTER TO LEGAL COUNSEL

(Ref: par. 22)

In connection with an audit of our financial statements at (balance sheet date) and for the (period) then ended, management of the Company has prepared, and furnished to our auditors (name and address of auditors), a description and evaluation of certain contingencies, including those set forth below involving matters with respect to which you have been engaged and to which you have devoted substantive attention on behalf of the Company in the form of legal consultation or representation. These contingencies are regarded by management of the Company as material for this purpose (management may indicate a materiality limit if an understanding has been reached with the auditor). Your response should include matters that existed at (balance sheet date) and during the period from that date to the date of your response.

[Alternative wording when management requests the lawyer to prepare the list that describes and evaluates pending or threatened litigation, claims, and assessments is as follows:

In connection with an audit of our financial statements as of (balance-sheet date) and for the (period) then ended, please furnish our auditors, (name and address of auditors), with the information requested below concerning certain contingencies involving matters with respect to which you have devoted substantive attention on behalf of the Company in the form of legal consultation or representation. [When a materiality limit has been established based on an understanding between management and the

16. Paragraph A14 of the clarified SAS *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*.

auditor, the following sentence should be added: This request is limited to contingencies amounting to (amount) individually or items involving lesser amounts that exceed (amount) in the aggregate.]

Pending or Threatened Litigation (Excluding Unasserted Claims)

[Ordinarily the information would include the following: (1) the nature of the litigation, (2) the progress of the case to date, (3) how management is responding or intends to respond to the litigation (for example, to contest the case vigorously or to seek an out-of-court settlement), and (4) an evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss.] This letter will serve as our consent for you to furnish to our auditor all the information requested herein. Accordingly, please furnish to our auditors such explanation, if any, that you consider necessary to supplement the foregoing information, including an explanation of those matters as to which your views may differ from those stated and an identification of the omission of any pending or threatened litigation, claims, and assessments or a statement that the list of such matters is complete.

[Alternative wording when management requests the lawyer to prepare the list that describes and evaluates pending or threatened litigation, claims, and assessments is as follows:]

Regarding pending or threatened litigation, claims, and assessments, please include in your response: (1) the nature of each matter, (2) the progress of each matter to date, (3) how the Company is responding or intends to respond (for example, to contest the case vigorously or seek an out-of-court settlement), and (4) an evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss.

Unasserted Claims and Assessments (Considered by Management to be Probable of Assertion and That, if Asserted, Would Have at Least a Reasonable Possibility of an Unfavorable Outcome)

[Ordinarily management's information would include the following: (1) the nature of the matter, (2) how management intends to respond if the claim is asserted, and (3) an evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss.] Please furnish to our auditors such explanation, if any, that you consider necessary to supplement the foregoing information, including an explanation of those matters as to which your views may differ from those stated.

We understand that whenever, in the course of performing legal services for us with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, if you have formed a professional conclusion that we should disclose or consider disclosure concerning such possible claim or assessment, as a matter of professional responsibility to us, you will so advise us and will consult with

us concerning the question of such disclosure and the applicable requirements of Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 450, *Contingencies*. Please specifically confirm to our auditors that our understanding is correct.

[Alternative wording when management requests the lawyer to prepare the list that describes and evaluates pending or threatened litigation, claims, and assessments is as follows:]

We have represented to our auditors that there are no unasserted possible claims or assessments that you have advised us are probable of assertion and must be disclosed in accordance with FASB ASC 450. We understand that whenever, in the course of performing legal services for us with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, you have formed a professional conclusion that we should disclose or consider disclosure concerning such possible claim or assessment, as a matter of professional responsibility to us, you will so advise us and will consult with us concerning the question of such disclosure and the applicable requirements of FASB ASC 450. Please specifically confirm to our auditors that our understanding is correct.

Please specifically identify the nature of and reasons for any limitation on your response.

[The auditor may request the client to inquire about additional matters, for example, unpaid or unbilled charges or specified information on certain contractually assumed obligations of the company, such as guarantees of indebtedness of others.]

[Alternative wording when management requests the lawyer to prepare the list that describes and evaluates pending or threatened litigation, claims, and assessments is as follows:]

Your response should include matters that existed as of (balance-sheet date) and during the period from that date to the effective date of your response. Please specifically identify the nature of and reasons for any limitations on your response. Our auditors expect to have the audit completed about (expected completion date). They would appreciate receiving your reply by that date with a specified effective date no earlier than (ordinarily two weeks before expected completion date).

[Wording that could be used in an audit inquiry letter, instead of the heading and first paragraph, when the client believes that there are no unasserted claims or assessments (to be specified to the lawyer for comment) that are probable of assertion and that, if asserted, would have a reasonable possibility of an unfavorable outcome as specified by Financial Accounting Standards Board *Accounting Standards Codification* 450, *Contingencies*, is as follows:

Unasserted claims and assessments—We have represented to our auditors that there are no unasserted possible claims that you have advised us are probable of assertion and must be disclosed, in accordance with Financial Accounting Standards Board *Accounting*

Standards Codification 450, *Contingencies*. (The second paragraph in the section relating to unasserted claims and assessments would not be altered.)]

A70.

EXHIBIT A: AMERICAN BAR ASSOCIATION STATEMENT OF POLICY REGARDING LAWYERS' RESPONSES TO AUDITORS' REQUESTS FOR INFORMATION (Ref: par. A48)

Note: This document, in the form herein set forth, was approved by the Board of Governors of the American Bar Association (ABA) in December 1975, which official action permitted its release to lawyers and accountants as the standard recommended by the ABA for the lawyer's response to letters of audit inquiry.

Source: *Statement on Auditing Standards No. 12, Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments* (AICPA, *Professional Standards*, vol. 1, AU sec. 337C)

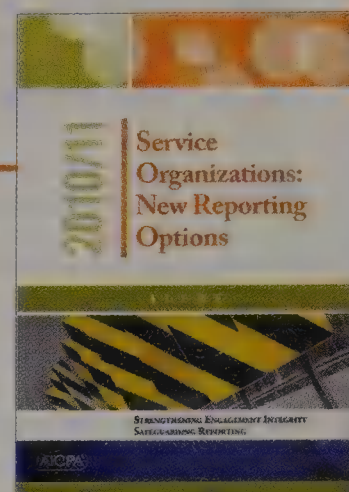
Preamble

The public interest in protecting the confidentiality of lawyer-client communications is fundamental. The American legal, political and economic systems depend heavily upon voluntary compliance with the law and upon ready access to a respected body of professionals able to interpret and advise on the law. The expanding complexity of our laws and governmental regulations increases the need for prompt, specific and unhampered lawyer-client communication. The benefits of such communication and early consultation underlie the strict statutory and ethical obligations of the lawyer to preserve the confidences and secrets of the client, as well as the long-recognized testimonial privilege for lawyer-client communication.

Both the Code of Professional Responsibility and the cases applying the evidentiary privilege recognize that the privilege against disclosure can be knowingly and voluntarily waived by the client. It is equally clear that disclosure to a third party may result in loss of the "confidentiality" essential to maintain the privilege. Disclosure to a third party of the lawyer-client communication on a particular subject may also destroy the privilege as to other communications on that subject. Thus, the mere disclosure by the lawyer to the outside auditor, with due client consent, of the substance of communications between the lawyer and client may significantly impair the client's ability in other contexts to maintain the confidentiality of such communications.

Under the circumstances a policy of audit procedure which requires clients to give consent and authorize lawyers to respond to general inquiries and disclose information to auditors concerning matters which have been communicated in confidence is essentially destructive of free and open communication and early consultation between lawyer and client. The institution of such a policy

What Happened to SAS 70?



It has become more common for CPAs in the practice of public accounting to be asked to provide assurance on subject matter other than financial statements.

Since 1992, SAS No. 70, *Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324) has been the source of the requirements and guidance for service auditors and user auditors. SAS No. 70 has been divided and replaced by two new standards. One is an attestation standard, and the other is an auditing standard. The requirements and guidance for a service auditor reporting on controls at a service organization relevant to user entities internal control over financial reporting have been placed in SSAE No. 16, *Reporting on Controls at a Service Organization* (AICPA, *Professional Standards*, vol. 1, AT sec. 801). The requirements and guidance for auditing the financial statements of entities that use service organizations remains in the auditing standards in clarified *SAS Audit Considerations Relating to an Entity Using a Service Organization*.

The auditing standards primarily provide guidance on reporting on an audit of financial statements, whereas the attestation standards primarily provide guidance on reporting on other subject matter. Moving the requirements for service auditors reporting on controls at a service organization to the attestation standards better reflects the nature of the work a service auditor performs. This change also aligns with the Accounting Standards Board's (ASB's) project to converge its

standards with those of the International Auditing and Assurance Standards Board (IAASB).

One of the new requirements in SSAE No. 16 is for the service auditor to obtain a written assertion from management of the service organization about the fairness of the presentation of its description of the service organization's system and about the suitability of the design. That assertion will either accompany the service auditor's report or be included in the description of the service organization's system.

In addition, to make practitioners aware of the various professional standards available to them for examining and reporting on controls at a service organization, and to help practitioners select the appropriate standard and related report for a particular engagement, the AICPA has introduced a series of three different Service Organization Control (SOC) reports (SOC 1, SOC 2, and SOC 3). This series encompasses the new SSAE No. 16, which retains the original purpose of SAS No. 70, and adds two new reporting options.

In addition to more detailed information on SOC reports, the new alert, *Service Organizations: New Reporting Options* provides illustrative written assertions by management of a service organization, as well as illustrative SOC reports. This alert is designed to provide professional guidelines that will enhance both consistency and quality in the performance of attest services.

To order the new edition of the *Service Organizations: New Reporting Options* visit www.cpa2biz.com or call 1-888-777-7077. For the paperback, ask for product # 0224811, member price: \$29.00. For the online subscription, ask for product # WDK-XX, member price \$29.00. **Save 10% with coupon code TDE.** Please order before 6/1/11.

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■ **AICPA National Not-for-Profit Industry Conference**
June 9-10, 2011, Marriott Wardman Park, Washington, DC

■ **AICPA Family Law Conference**
May 18-20, 2011, Bellagio, Las Vegas, NV

■ **AICPA Practitioners Symposium and TECH+ Conference**
June 13-15, 2011, Aria, Las Vegas, NV

would inevitably discourage management from discussing potential legal problems with counsel for fear that such discussion might become public and precipitate a loss to or possible liability of the business enterprise and its stockholders that might otherwise never materialize.

It is also recognized that our legal, political and economic systems depend to an important extent on public confidence in published financial statements. To meet this need the accounting profession must adopt and adhere to standards and procedures that will command confidence in the auditing process. It is not, however, believed necessary, or sound public policy, to intrude upon the confidentiality of the lawyer-client relationship in order to command such confidence. On the contrary, the objective of fair disclosure in financial statements is more likely to be better served by maintaining the integrity of the confidential relationship between lawyer and client, thereby strengthening corporate management's confidence in counsel and encouraging its readiness to seek advice of counsel and to act in accordance with counsel's advice.

Consistent with the foregoing public policy considerations, it is believed appropriate to distinguish between, on the one hand, litigation which is pending or which a third party has manifested to the client a present intention to commence and, on the other hand, other contingencies of a legal nature or having legal aspects. As regards the former category, unquestionably the lawyer representing the client in a litigation matter may be the best source for a description of the claim or claims asserted, the client's position (e.g., denial, contest, etc.), and the client's possible exposure in the litigation (to the extent the lawyer is in a position to do so). As to the latter category, it is submitted that, for the reasons set forth above, it is not in the public interest for the lawyer to be required to respond to general inquiries from auditors concerning possible claims.

It is recognized that the disclosure requirements for enterprises subject to the reporting requirements of the Federal securities laws are a major concern of managements and counsel, as well as auditors. It is submitted that compliance therewith is best assured when clients are afforded maximum encouragement, by protecting lawyer-client confidentiality, freely to consult counsel. Likewise, lawyers must be keenly conscious of the importance of their clients being competently advised in these matters.

Statement of Policy

NOW, THEREFORE, BE IT RESOLVED that it is desirable and in the public interest that this Association adopt the following Statement of Policy regarding the appropriate scope of the lawyer's response to the auditor's request, made by the client at the request of the auditor, for information concerning matters referred to the lawyer during the course of his representation of the client:

1. *Client Consent to Response.* The lawyer may properly respond to the auditor's requests for information concerning loss contingencies (the term and

concept established by Statement of Financial Accounting Standards No. 5,^{*} promulgated by the Financial Accounting Standards Board in March 1975 and discussed in Paragraph 5.1 of the accompanying Commentary), to the extent hereinafter set forth, subject to the following:

- a. Assuming that the client's initial letter requesting the lawyer to provide information to the auditor is signed by an agent of the client having apparent authority to make such a request, the lawyer may provide to the auditor information requested, without further consent, unless such information discloses a confidence or a secret or requires an evaluation of a claim.
 - b. In the normal case, the initial request letter does not provide the necessary consent to the disclosure of a confidence or secret or to the evaluation of a claim since that consent may only be given after full disclosure to the client of the legal consequences of such action.
 - c. Lawyers should bear in mind, in evaluating claims, that an adverse party may assert that any evaluation of potential liability is an admission.
 - d. In securing the client's consent to the disclosure of confidences or secrets, or the evaluation of claims, the lawyer may wish to have a draft of his letter reviewed and approved by the client before releasing it to the auditor; in such cases, additional explanation would in all probability be necessary so that the legal consequences of the consent are fully disclosed to the client.
2. *Limitation on Scope of Response.* It is appropriate for the lawyer to set forth in his response, by way of limitation, the scope of his engagement by the client. It is also appropriate for the lawyer to indicate the date as of which information is furnished and to disclaim any undertaking to advise the auditor of changes which may thereafter be brought to the lawyer's attention. *Unless the lawyer's response indicates otherwise, (a) it is properly limited to matters which have been given substantive attention by the lawyer in the form of legal consultation and, where appropriate, legal representation since the beginning of the period or periods being reported upon, and (b) if a law firm or a law department, the auditor may assume that the firm or department has endeavored, to the extent believed necessary by the firm or department, to determine from lawyers currently in the firm or department who have performed services for the client since the beginning of the fiscal period under audit whether such services involved substantive attention in the form of legal consultation concern-*

ing those loss contingencies referred to in Paragraph 5(a) below but, beyond that, no review has been made of any of the client's transactions or other matters for the purpose of identifying loss contingencies to be described in the response.[†]

3. *Response may be Limited to Material Items.* In response to an auditor's request for disclosure of loss contingencies of a client, it is appropriate for the lawyer's response to indicate that the response is limited to items which are considered individually or collectively material to the presentation of the client's financial statements.
4. *Limited Responses.* Where the lawyer is limiting his response in accordance with the Statement of Policy, his response should so indicate (see Paragraph 8). If in any other respect the lawyer is not undertaking to respond to or comment on particular aspects of the inquiry when responding to the auditor, he should consider advising the auditor that his response is limited, in order to avoid any inference that the lawyer has responded to all aspects; otherwise, he may be assuming a responsibility which he does not intend.
5. *Loss Contingencies.* When properly requested by the client, it is appropriate for the lawyer to furnish to the auditor information concerning the following matters if the lawyer has been engaged by the client to represent or advise the client professionally with respect thereto and he has devoted substantive attention to them in the form of legal representation or consultation:
 - a. *overtly threatened or pending litigation, whether or not specified by the client;*
 - b. *a contractually assumed obligation which the client has specifically identified and upon which the client has specifically requested, in the inquiry letter or a supplement thereto, comment to the auditor;*
 - c. *an unasserted possible claim or assessment which the client has specifically identified and upon which the client has specifically requested, in the inquiry letter or a supplement thereto, comment to the auditor.*

With respect to clause (a), overtly threatened litigation means that a potential claimant has manifested to the client an awareness of and present intention to assert a possible claim or assessment unless the likelihood of litigation (or of settlement when litigation would normally be avoided) is considered remote. With respect to clause (c), where there has been no manifestation by a potential claimant of an awareness of and present intention to assert a possible claim or assessment, consistent with the considerations and concerns outlined in the Preamble and Paragraph 1 hereof, the client should request the lawyer to furnish information to the auditor only if the client has determined that it is probable that a possible claim will be asserted, that there is a reasonable possibility that the outcome (assuming such assertion) will be unfavorable,

^{*} In July 2009, the Financial Accounting Standards Board (FASB) issued FASB Accounting Standards Codification™ (ASC) as authoritative. FASB ASC is now the source of authoritative U.S. accounting and reporting standards for nongovernmental entities, in addition to guidance issued by the Securities and Exchange Commission (SEC). As of July 1, 2009, all other nongrandfathered, non-SEC accounting literature not included in FASB ASC became nonauthoritative. FASB Statement No. 5, *Accounting for Contingencies*, has been codified as FASB ASC 450, *Contingencies*.

[†] As contemplated by Paragraph 8 of this Statement of Policy, this sentence is intended to be the subject of incorporation by reference as therein provided.

and that the resulting liability would be material to the financial condition of the client. Examples of such situations might (depending in each case upon the particular circumstances) include the following: (i) a catastrophe, accident or other similar physical occurrence in which the client's involvement is open and notorious, or (ii) an investigation by a government agency where enforcement proceedings have been instituted or where the likelihood that they will not be instituted is remote, under circumstances where assertion of one or more private claims for redress would normally be expected, or (iii) a public disclosure by the client acknowledging (and thus focusing attention upon) the existence of one or more probable claims arising out of an event or circumstance. In assessing whether or not the assertion of a possible claim is probable, it is expected that the client would normally employ, by reason of the inherent uncertainties involved and insufficiency of available data, concepts parallel to those used by the lawyer (discussed below) in assessing whether or not an unfavorable outcome is probable; thus, assertion of a possible claim would be considered probable only when the prospects of its being asserted seem reasonably certain (i.e., supported by extrinsic evidence strong enough to establish a presumption that it will happen) and the prospects of nonassertion seem slight.

It would not be appropriate, however, for the lawyer to be requested to furnish information in response to an inquiry letter or supplement thereto if it appears that (a) the client has been required to specify unasserted possible claims without regard to the standard suggested in the preceding paragraph, or (b) the client has been required to specify all or substantially all unasserted possible claims as to which legal advice may have been obtained, since, in either case, such a request would be in substance a general inquiry and would be inconsistent with the intent of this Statement of Policy.

The information that lawyers may properly give to the auditor concerning the foregoing matters would include (to the extent appropriate) an identification of the proceedings or matter, the stage of proceedings, the claim(s) asserted, and the position taken by the client.

In view of the inherent uncertainties, the lawyer should normally refrain from expressing judgments as to outcome except in those relatively few clear cases where it appears to the lawyer that an unfavorable outcome is either "probable" or "remote"; for purposes of any such judgment it is appropriate to use the following meanings:

- i. *probable*—an unfavorable outcome for the client is probable if the prospects of the claimant not succeeding are judged to be extremely doubtful and the prospects for success by the client in its defense are judged to be slight.
- ii. *remote*—an unfavorable outcome is remote if the prospects for the client not succeed-

ing in its defense are judged to be extremely doubtful and the prospects of success by the claimant are judged to be slight.

If, in the opinion of the lawyer, considerations within the province of his professional judgment bear on a particular loss contingency to the degree necessary to make an informed judgment, he may in appropriate circumstances communicate to the auditor his view that an unfavorable outcome is "probable" or "remote," applying the above meanings. No inference should be drawn, from the absence of such a judgment, that the client will not prevail.

The lawyer also may be asked to estimate, in dollar terms, the potential amount of loss or range of loss in the event that an unfavorable outcome is not viewed to be "remote." In such a case, the amount or range of potential loss will normally be as inherently impossible to ascertain, with any degree of certainty, as the outcome of the litigation. Therefore, it is appropriate for the lawyer to provide an estimate of the amount or range of potential loss (if the outcome should be unfavorable) only if he believes that the probability of inaccuracy of the estimate of the amount or range of potential loss is slight.

The considerations bearing upon the difficulty in estimating loss (or range of loss) where pending litigation is concerned are obviously even more compelling in the case of unasserted possible claims. In most cases, the lawyer will not be able to provide any such estimate to the auditor.

As indicated in Paragraph 4 hereof, the auditor may assume that all loss contingencies specified by the client in the manner specified in clauses (b) and (c) above have received comment in the response, unless otherwise therein indicated. The lawyer should not be asked, nor need the lawyer undertake, to furnish information to the auditor concerning loss contingencies except as contemplated by this Paragraph 5.

6. *Lawyer's Professional Responsibility.* Independent of the scope of his response to the auditor's request for information, the lawyer, depending upon the nature of the matters as to which he is engaged, may have as part of his professional responsibility to his client an obligation to advise the client concerning the need for or advisability of public disclosure of a wide range of events and circumstances. The lawyer has an obligation not knowingly to participate in any violation by the client of the disclosure requirements of the securities laws. In appropriate circumstances, the lawyer also may be required under the Code of Professional Responsibility to resign his engagement if his advice concerning disclosures is disregarded by the client. The auditor may properly assume that whenever, in the course of performing legal services for the client with respect to a matter recognized to involve an unasserted possible claim or assessment which may call for financial statement disclosure, the lawyer has formed a professional conclusion that the client must disclose or con-

sider disclosure concerning such possible claim or assessment, the lawyer, as a matter of professional responsibility to the client, will so advise the client and will consult with the client concerning the question of such disclosure and the applicable requirements[†] of FAS 5.

7. *Limitation on Use of Response.* Unless otherwise stated in the lawyer's response, it shall be solely for the auditor's information in connection with his audit of the financial condition of the client and is not to be quoted in whole or in part or otherwise referred to in any financial statements of the client or related documents, nor is it to be filed with any governmental agency or other person, without the lawyer's prior written consent.[‡] Notwithstanding such limitation, the response can properly be furnished to others in compliance with court process or when necessary in order to defend the auditor against a challenge of the audit by the client or a regulatory agency, provided that the lawyer is given written notice of the circumstances at least twenty days before the response is so to be furnished to others, or as long in advance as possible if the situation does not permit such period of notice.[†]
8. *General.* This Statement of Policy, together with the accompanying Commentary (which is an integral part hereof), has been developed for the general guidance of the legal profession. In a particular case, the lawyer may elect to supplement or modify the approach hereby set forth. If desired, this Statement of Policy may be incorporated by reference in the lawyer's response by the following statement: "This response is limited by, and in accordance with, the ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information (December 1975); without limiting the generality of the foregoing, the limitations set forth in such Statement on the scope and use of this response (Paragraphs 2 and 7) are specifically incorporated herein by reference, and any description herein of any 'loss contingencies' is qualified in its entirety by Paragraph 5 of the Statement and the accompanying Commentary (which is an integral part of the Statement)."

The accompanying Commentary is an integral part of this Statement of Policy.

Commentary

Paragraph 1 (Client Consent to Response)

In responding to any aspect of an auditor's inquiry letter, the lawyer must be guided by his ethical obligations as set forth in the Code of Professional Responsibility. Under Canon 4 of the Code of Professional Responsibility a lawyer is enjoined to preserve the client's confidences (defined as information

[†] Under FAS 5, when there has been no manifestation by a potential claimant of an awareness of a possible claim or assessment, disclosure of an unasserted possible claim is required only if the enterprise concludes that (i) it is probable that a claim will be asserted, (ii) there is a reasonable possibility, if the claim is in fact asserted, that the outcome will be unfavorable, and (iii) the liability resulting from such unfavorable outcome would be material to its financial condition.

[‡] As contemplated by Paragraph 8 of this Statement of Policy, this sentence is intended to be the subject of incorporation by reference as therein provided.

protected by the attorney-client privilege under applicable law) and the client's secrets (defined as other information gained in the professional relationship that the client has requested be held inviolate or the disclosure of which would be embarrassing or would be likely to be detrimental to the client). The observance of this ethical obligation, in the context of public policy, "... not only facilitates the full development of facts essential to proper representation of the client but also encourages laymen to seek early legal assistance." (Ethical Consideration 4-1).

The lawyer's ethical obligation therefore includes a much broader range of information than that protected by the attorney-client privilege. As stated in Ethical Consideration 4-4: "The attorney-client privilege is more limited than the ethical obligation of a lawyer to guard the confidences and secrets of his client. This ethical precept, unlike the evidentiary privilege, exists without regard to the nature or source of information or the fact that others share the knowledge."

In recognition of this ethical obligation, the lawyer should be careful to disclose fully to his client any confidence, secret or evaluation that is to be revealed to another, including the client's auditor, and to satisfy himself that the officer or agent of a corporate client consenting to the disclosure understands the legal consequences thereof and has authority to provide the required consent.

The law in the area of attorney-client privilege and the impact of statements made in letters to auditors upon that privilege has not yet been developed. Based upon cases treating the attorney-client privilege in other contexts, however, certain generalizations can be made with respect to the possible impact of statements in letters to auditors.

It is now generally accepted that a corporation may claim the attorney-client privilege. Whether the privilege extends beyond the control group of the corporation (a concept found in the existing decisional authority), and if so, how far, is yet unresolved.

If a client discloses to a third party a part of any privileged communication he has made to his attorney, there may have been a waiver as to the whole communication; further, it has been suggested that giving accountants access to privileged statements made to attorneys may waive any privilege as to those statements. Any disclosure of privileged communications relating to a particular subject matter may have the effect of waiving the privilege on other communications with respect to the same subject matter.

To the extent that the lawyer's knowledge of unasserted possible claims is obtained by means of confidential communications from the client, any disclosure thereof might constitute a waiver as fully as if the communication related to pending claims.

A further difficulty arises with respect to requests for evaluation of either pending or unasserted possible claims. It might be argued that any evaluation of a claim, to the extent based upon a confidential communication with the client, waives any privilege with respect to that claim.

Another danger inherent in a lawyer's placing a

value on a claim, or estimating the likely result, is that such a statement might be treated as an admission or might be otherwise prejudicial to the client.

The Statement of Policy has been prepared in the expectation that judicial development of the law in the foregoing areas will be such that useful communication between lawyers and auditors in the manner envisaged in the Statement will not prove prejudicial to clients engaged in or threatened with adversary proceedings. If developments occur contrary to this expectation, appropriate review and revision of the Statement of Policy may be necessary.

Paragraph 2 (Limitation on Scope of Response)

In furnishing information to an auditor, the lawyer can properly limit himself to loss contingencies which he is handling on a substantive basis for the client in the form of legal consultation (advice and other attention to matters not in litigation by the lawyer in his professional capacity) or legal representation (counsel of record or other direct professional responsibility for a matter in litigation). Some auditors' inquiries go further and ask for information on matters of which the lawyer "has knowledge." Lawyers are concerned that such a broad request may be deemed to include information coming from a variety of sources including social contact and third party contacts as well as professional engagement and that the lawyer might be criticized or subjected to liability if some of this information is forgotten at the time of the auditor's request.

It is also believed appropriate to recognize that the lawyer will not necessarily have been authorized to investigate, or have investigated, all legal problems of the client, even when on notice of some facts which might conceivably constitute a legal problem upon exploration and development. Thus, consideration in the form of preliminary or passing advice, or regarding an incomplete or hypothetical state of facts, or where the lawyer has not been requested to give studied attention to the matter in question, would not come within the concept of "substantive attention" and would therefore be excluded. Similarly excluded are matters which may have been mentioned by the client but which are not actually being handled by the lawyer. Paragraph 2 undertakes to deal with these concerns.

Paragraph 2 is also intended to recognize the principle that the appropriate lawyer to respond as to a particular loss contingency is the lawyer having charge of the matter for the client (e.g., the lawyer representing the client in a litigation matter and/or the lawyer having overall charge and supervision of the matter), and that the lawyer not having that kind of role with respect to the matter should not be expected to respond merely because of having become aware of its existence in a general or incidental way.

The internal procedures to be followed by a law firm or law department may vary based on factors such as the scope of the lawyer's engagement and the complexity and magnitude of the client's affairs. Such procedures could, but need not, include use of a docket system to record litigation, consultation

with lawyers in the firm or department having principal responsibility for the client's affairs or other procedures which, in light of the cost to the client, are not disproportionate to the anticipated benefit to be derived. Although these procedures may not necessarily identify all matters relevant to the response, the evolution and application of the lawyer's customary procedures should constitute a reasonable basis for the lawyer's response.

As the lawyer's response is limited to matters involving his professional engagement as counsel, such response should not include information concerning the client which the lawyer receives in another role. In particular, a lawyer who is also a director or officer of the client would not include information which he received as a director or officer unless the information was also received (or, absent the dual role, would in the normal course be received) in his capacity as legal counsel in the context of his professional engagement. Where the auditor's request for information is addressed to a law firm as a firm, the law firm may properly assume that its response is not expected to include any information which may have been communicated to the particular individual by reason of his serving in the capacity of director or officer of the client. The question of the individual's duty, in his role as a director or officer, is not here addressed.

Paragraph 3 (Response May Cover only Material Items in Certain Cases)

Paragraph 3 makes it clear that the lawyer may optionally limit his responses to those items which are individually or collectively material to the auditor's inquiry. If the lawyer takes responsibility for making a determination that a matter is not material for the purposes of his response to the audit inquiry, he should make it clear that his response is so limited. The auditor, in such circumstance, should properly be entitled to rely upon the lawyer's response as providing him with the necessary corroboration. It should be emphasized that the employment of inside general counsel by the client should not detract from the acceptability of his response since inside general counsel is as fully bound by the professional obligations and responsibilities contained in the Code of Professional Responsibility as outside counsel. If the audit inquiry sets forth a definition of materiality but the lawyer utilizes a different test of materiality, he should specifically so state. The lawyer may wish to reach an understanding with the auditor concerning the test of materiality to be used in his response, but he need not do so if he assumes responsibility for the criteria used in making materiality determinations. Any such understanding with the auditor should be referred to or set forth in the lawyer's response. In this connection, it is assumed that the test of materiality so agreed upon would not be so low in amount as to result in a disservice to the client and an unreasonable burden on counsel.

Paragraph 4 (Limited Responses)

The Statement of Policy is designed to recognize the obligation of the auditor to complete the procedures

considered necessary to satisfy himself as to the fair presentation of the company's financial condition and results, in order to render a report which includes an opinion not qualified because of a limitation on the scope of the audit. In this connection, reference is made to SEC Accounting Series Release No. 90 [Financial Reporting Release No. 1, section 607.01(b)], in which it is stated:

"A 'subject to' or 'except for' opinion paragraph in which these phrases refer to the scope of the audit, indicating that the accountant has not been able to satisfy himself on some significant element in the financial statements, is not acceptable in certificates filed with the Commission in connection with the public offering of securities. The 'subject to' qualification is appropriate when the reference is to a middle paragraph or to footnotes explaining the status of matters which cannot be resolved at statement date."

Paragraph 5 (Loss Contingencies)

Paragraph 5 of the Statement of Policy summarizes the categories of "loss contingencies" about which the lawyer may furnish information to the auditor. The term loss contingencies and the categories relate to concepts of accounting accrual and disclosure specified for the accounting profession in Statement of Financial Accounting Standards No. 5* ("FAS 5") issued by the Financial Accounting Standards Board in March, 1975.

5.1 Accounting Requirements

To understand the significance of the auditor's inquiry and the implications of any response the lawyer may give, the lawyer should be aware of the following accounting concepts and requirements set out in FAS 5:¹¹

- a. A "loss contingency" is an existing condition, situation or set of circumstances involving uncertainty as to possible loss to an enterprise that will ultimately be resolved when one or more events occur or fail to occur. Resolutions of the uncertainty may confirm the loss or impairment of an asset or the incurrence of a liability. (Para. 1)
- b. When a "loss contingency" exists, the likelihood that a future event or events will confirm the loss or impairment of an asset or the incurrence of a liability can range from probable to remote. There are three areas within that range, defined as follows:
 - i. *Probable*—"The future event or events are likely to occur."
 - ii. *Reasonably possible*—"The chance of the future event or events occurring is more than remote but less than likely."
 - iii. *Remote*—"The chance of the future event or events occurring is slight." (Para. 3)

- c. *Accrual* in a client's financial statements by a charge to income of the period will be required if both the following conditions are met:

- i. "Information available prior to issuance of the financial statements indicates that it is *probable* that an asset had been impaired or a liability had been incurred at the date of the financial statements. It is implicit in this condition that it must be *probable* that one or more future events will occur confirming the fact of the loss." (emphasis added; footnote omitted)
- ii. "The amount of loss can be reasonably estimated." (Para. 8)
- d. If there is no *accrual* of the loss contingency in the client's financial statements because one of the two conditions outlined in (c) above are not met, disclosure may be required as provided in the following:

"If no accrual is made for a loss contingency because one or both of the conditions in paragraph 8 are not met, or if an exposure to loss exists in excess of the amount accrued pursuant to the provisions of paragraph 8, *disclosure of the contingency shall be made when there is at least a reasonable possibility that a loss or an additional loss may have been incurred. The disclosure shall indicate the nature of the contingency and shall give an estimate of the possible loss or range of loss or state that such an estimate cannot be made. Disclosure is not required of a loss contingency involving an unasserted claim or assessment when there has been no manifestation by potential claimant of an awareness of a possible claim or assessment unless it is considered probable that a claim will be asserted and there is a reasonable possibility that the outcome will be unfavorable.*" (emphasis added; footnote omitted) (Para. 10)

- e. The accounting requirements recognize or specify that (i) the opinions or views of counsel are not the sole source of audit evidence in making determinations about the accounting recognition or treatment to be given to litigation, and (ii) the fact that the lawyer is notable to express an opinion that the outcome will be favorable does not necessarily require an accrual of a loss. Paragraphs 36 and 37 of FAS 5 state as follows:

"If the underlying cause of the litigation, claim, or assessment is an event occurring before the date of an enterprise's financial statements, the probability of an outcome unfavorable to the enterprise must be assessed to determine whether the condition in paragraph 8(a) is met. Among the factors that should be considered are the nature of the litigation, claim, or assessment, the progress of the case (including progress after the date of the financial statements but before those statements are issued), the opinions or views of legal counsel and other advisers, the experience of the enterprise in similar cases, the experience of other enter-

prises, and any decision of the enterprise's management as to how the enterprise intends to respond to the lawsuit, claim, or assessment (for example, a decision to contest the case vigorously or a decision to seek an out-of-court settlement). The fact that legal counsel is unable to express an opinion that the outcome will be favorable to the enterprise should not necessarily be interpreted to mean that the condition for accrual of a loss in paragraph 8(a) is met.

"The filing of a suit or formal assertion of a claim or assessment does not automatically indicate that accrual of a loss may be appropriate. The degree of probability of an unfavorable outcome must be assessed. The condition for accrual in paragraph 8(a) would be met if an unfavorable outcome is determined to be probable. If an unfavorable outcome is determined to be reasonably possible but not probable, or if the amount of loss cannot be reasonably estimated, accrual would be inappropriate, but disclosure would be required by paragraph 10 of this Statement."

- f. Paragraph 38 of FAS 5 focuses on certain examples concerning the determination by the enterprise whether an assertion of an *unasserted possible claim* may be considered probable:

"With respect to unasserted claims and assessments, an enterprise must determine the degree of probability that a suit may be filed or a claim or assessment may be asserted and the possibility of an unfavorable outcome. For example, a catastrophe, accident, or other similar physical occurrence predictably engenders claims for redress, and in such circumstances their assertion may be probable; similarly, an investigation of an enterprise by a governmental agency, if enforcement proceedings have been or are likely to be instituted, is often followed by private claims for redress, and the probability of their assertion and the possibility of loss should be considered in each case. By way of further example, an enterprise may believe there is a possibility that it has infringed on another enterprise's patent rights, but the enterprise owning the patent rights has not indicated an intention to take any action and has not even indicated an awareness of the possible infringement. In that case, a judgment must first be made as to whether the assertion of a claim is probable. If the judgment is that assertion is not probable, no accrual or disclosure would be required. On the other hand, if the judgment is that assertion is probable, then a second judgment must be made as to the degree of probability of an unfavorable outcome. If an unfavorable outcome is probable and the amount of loss can be reasonably estimated, accrual of a loss is required by paragraph 8. If an unfavorable outcome is probable but the amount of loss

* In July 2009, FASB issued FASB ASC as authoritative. FASB ASC is now the source of authoritative U.S. accounting and reporting standards for nongovernmental entities, in addition to guidance issued by the SEC. As of July 1, 2009, all other nongrandfathered, non-SEC accounting literature not included in FASB ASC became nonauthoritative. FASB Statement No. 5 has been codified as FASB ASC 450.

¹¹ Citations are to paragraph numbers of FAS 5.

cannot be reasonably estimated, accrual would not be appropriate, but disclosure would be required by paragraph 10. If an unfavorable outcome is reasonably possible but not probable, disclosure would be required by paragraph 10."

For a more complete presentation of FAS 5, reference is made to AU section 337B, *Exhibit I—Excerpts From Financial Accounting Standards Board Accounting Standards Codification 450, Contingencies* (AICPA, *Professional Standards*, vol. 1), in which are set forth excerpts selected by the AICPA as relevant to a Statement on Auditing Standards, issued by its Auditing Standards Executive Committee, captioned "Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments."

5.2 Lawyer's Response

Concepts of probability inherent in the usage of terms like "probable" or "reasonably possible" or "remote" mean different things in different contexts. Generally, the outcome of, or the loss which may result from, litigation cannot be assessed in any way that is comparable to a statistically or empirically determined concept of "probability" that may be applicable when determining such matters as reserves for warranty obligations or accounts receivable or loan losses when there is a large number of transactions and a substantial body of known historical experience for the enterprise or comparable enterprises. While lawyers are accustomed to counseling clients during the progress of litigation as to the possible amount required for settlement purposes, the estimated risks of the proceedings at particular times and the possible application or establishment of points of law that may be relevant, such advice to the client is not possible at many stages of the litigation and may change dramatically depending upon the development of the proceedings. Lawyers do not generally quantify for clients the "odds" in numerical terms; if they do, the quantification is generally only undertaken in an effort to make meaningful, for limited purposes, a whole host of judgmental factors applicable at a particular time, without any intention to depict "probability" in any statistical, scientific or empirically-grounded sense. Thus, for example, statements that litigation is being defended vigorously and that the client has meritorious defenses do not, and do not purport to, make a statement about the probability of outcome in any measurable sense.

Likewise, the "amount" of loss—that is, the total of costs and damages that ultimately might be assessed against a client—will, in most litigation, be a subject of wide possible variance at most stages; it is the rare case where the amount is precise and where the question is whether the client against which claim is made is liable either for all of it or none of it.

In light of the foregoing considerations, it must be concluded that, as a general rule, it should not be anticipated that meaningful quantifications of "probability" of outcome or amount of damages can be given by lawyers in assessing litigation. To pro-

vide content to the definitions set forth in Paragraph 5 of the Statement of Policy, this Commentary amplifies the meanings of the terms under discussion, as follows:

"probable"—An unfavorable outcome is normally "probable" if, but only if, investigation, preparation (including development of the factual data and legal research) and progress of the matter have reached a stage where a judgment can be made, taking all relevant factors into account which may affect the outcome, that it is extremely doubtful that the client will prevail.

"remote"—The prospect for an unfavorable outcome appears, at the time, to be slight; i.e., it is extremely doubtful that the client will not prevail. Normally, this would entail the ability to make an unqualified judgment, taking into account all relevant factors which may affect the outcome, that the client may confidently expect to prevail on a motion for summary judgment on all issues due to the clarity of the facts and the law.

In other words, for purposes of the lawyer's response to the request to advise auditors about litigation, an unfavorable outcome will be "probable" only if the chances of the client prevailing appear slight and of the claimant losing appear extremely doubtful; it will be "remote" when the client's chances of losing appear slight and of not winning appear extremely doubtful. It is, therefore, to be anticipated that, in most situations, an unfavorable outcome will be neither "probable" nor "remote" as defined in the Statement of Policy.

The discussion above about the very limited basis for furnishing judgments about the outcome of litigation applies with even more force to a judgment concerning whether or not the assertion of a claim not yet asserted is "probable." That judgment will infrequently be one within the professional competence of lawyers and therefore the lawyer should not undertake such assessment except where such judgment may become meaningful because of the presence of special circumstances, such as catastrophes, investigations and previous public disclosure as cited in Paragraph 5 of the Statement of Policy, or similar extrinsic evidence relevant to such assessment. Moreover, it is unlikely, absent relevant extrinsic evidence, that the client or anyone else will be in a position to make an informed judgment that assertion of a possible claim is "probable" as opposed to "reasonably possible" (in which event disclosure is not required). In light of the legitimate concern that the public interest would not be well served by resolving uncertainties in a way that invites the assertion of claims or otherwise causes unnecessary harm to the client and its stockholders, a decision to treat an unasserted claim as "probable" of assertion should be based only upon compelling judgment.

Consistent with these limitations believed appropriate for the lawyer, he should not represent to the auditor, nor should any inference from his response be drawn, that the unasserted possible claims identified by the client (as contemplated by Paragraph 5(c) of the Statement of Policy) represent

all such claims of which the lawyer may be aware or that he necessarily concurs in his client's determination of which unasserted possible claims warrant specification by the client; within proper limits, this determination is one which the client is entitled to make—and should make—and it would be inconsistent with his professional obligations for the lawyer to volunteer information arising from his confidential relationship with his client.

As indicated in Paragraph 5, the lawyer also may be asked to estimate the potential loss (or range) in the event that an unfavorable outcome is not viewed to be "remote." In such a case, the lawyer would provide an estimate only if he believes that the probability of inaccuracy of the estimate of the range or amount is slight. What is meant here is that the estimate of amount of loss presents the same difficulty as assessment of outcome and that the same formulation of "probability" should be used with respect to the determination of estimated loss amounts as should be used with respect to estimating the outcome of the matter.

In special circumstances, with the proper consent of the client, the lawyer may be better able to provide the auditor with information concerning loss contingencies through conferences where there is opportunity for more detailed discussion and interchange. However, the principles set forth in the Statement of Policy and this Commentary are fully applicable to such conferences.

Subsumed throughout this discussion is the ongoing responsibility of the lawyer to assist his client, at the client's request, in complying with the requirements of FAS 5 to the extent such assistance falls within his professional competence. This will continue to involve, to the extent appropriate, privileged discussions with the client to provide a better basis on which the client can make accrual and disclosure determinations in respect of its financial statements.

In addition to the considerations discussed above with respect to the making of any judgment or estimate by the lawyer in his response to the auditor, including with respect to a matter specifically identified by the client, the lawyer should also bear in mind the risk that the furnishing of such a judgment or estimate to any one other than the client might constitute an admission or be otherwise prejudicial to the client's position in its defense against such litigation or claim (see Paragraph 1 of the Statement of Policy and of this Commentary).

Paragraph 6 (Lawyer's Professional Responsibility)

The client must satisfy whatever duties it has relative to timely disclosure, including appropriate disclosure concerning material loss contingencies, and, to the extent such matters are given substantive attention in the form of legal consultation, the lawyer, when his engagement is to advise his client concerning a disclosure obligation, has a responsibility to advise his client concerning its obligations in this regard. Although lawyers who normally confine themselves to a legal specialty such as tax, antitrust, patent or admiralty law, unlike lawyers

consulted about SEC or general corporate matters, would not be expected to advise generally concerning the client's disclosure obligations in respect of a matter on which the lawyer is working, the legal specialist should counsel his client with respect to the client's obligations under FAS 5 to the extent contemplated herein. Without regard to legal specialty, the lawyer should be mindful of his professional responsibility to the client described in Paragraph 6 of the Statement of Policy concerning disclosure.

The lawyer's responsibilities with respect to his client's disclosure obligations have been a subject of considerable discussion and there may be, in due course, clarification and further guidance in this regard. In any event, where in the lawyer's view it is clear that (i) the matter is of material importance and seriousness, and (ii) there can be no reasonable doubt that its non-disclosure in the client's financial statements would be a violation of law giving rise to material claims, rejection by the client of his advice to call the matter to the attention of the auditor would almost certainly require the lawyer's withdrawal from employment in accordance with the Code of Professional Responsibility. (See, e.g., Disciplinary Rule 7-102 (A)(3) and (7), and Disciplinary Rule 2-110 (B)(2).) Withdrawal under such circumstances is obviously undesirable and might present serious problems for the client. Accordingly, in the context of financial accounting and reporting for loss contingencies arising from unasserted claims, the standards for which are contained in FAS 5, clients should be urged to disclose to the auditor information concerning an unasserted possible claim or assessment (not otherwise specifically identified by the client) where in the course of the services performed for the client it has become clear to the lawyer that (i) the client has no reasonable basis to conclude that assertion of the claim is not probable (employing the concepts hereby enunciated) and (ii) given the probability of assertion, disclosure of the loss contingency in the client's financial statements is beyond reasonable dispute required.

Paragraph 7 (Limitation on Use of Response)

Some inquiry letters make specific reference to, and one might infer from others, an intention to quote verbatim or include the substance of the lawyer's reply in footnotes to the client's financial statements. Because the client's prospects in pending litigation may shift as a result of interim developments, and because the lawyer should have an opportunity, if quotation is to be made, to review the footnote in full, it would seem prudent to limit the use of the lawyer's reply letter. Paragraph 7 sets out such a limitation.

Paragraph 7 also recognizes that it may be in the client's interest to protect information contained in the lawyer's response to the auditor, if and to the extent possible, against unnecessary further disclosure or use beyond its intended purpose of informing the auditor. For example, the response may contain information which could prejudice efforts to negotiate a favorable settlement of a pending lit-

igation described in the response. The requirement of consent to further disclosure, or of reasonable advance notice where disclosure may be required by court process or necessary in defense of the audit, is designed to give the lawyer an opportunity to consult with the client as to whether consent should be refused or limited or, in the case of legal process or the auditor's defense of the audit, as to whether steps can and should be taken to challenge the necessity of further disclosure or to seek protective measures in connection therewith. It is believed that the suggested standard of twenty days advance notice would normally be a minimum reasonable time for this purpose.

Paragraph 8 (General)

It is reasonable to assume that the Statement of Policy will receive wide distribution and will be readily available to the accounting profession. Specifically, the Statement of Policy has been reprinted as Exhibit II to the Statement on Auditing Standards, "Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments," issued by the Auditing Standards Executive Committee of the American Institute of Certified Public Accountants. Accordingly, the mechanic for its incorporation by reference will facilitate lawyer-auditor communication. The incorporation is intended to include not only limitations, such as those provided by Paragraphs 2 and 7 of the Statement of Policy, but also the explanatory material set forth in this Commentary.

Annex A

[Illustrative forms of letters for full response by outside practitioner or law firm and inside general counsel to the auditor's inquiry letter. These illustrative forms, which are not part of the Statement of Policy, have been prepared by the Committee on Audit Inquiry Responses solely in order to assist those who may wish to have, for reference purposes, a form of response which incorporates the principles of the Statement of Policy and accompanying Commentary. Other forms of response letters will be appropriate depending on the circumstances.]

Illustrative Form of Letter for Use by Outside Practitioner or Law Firm:

[Name and Address of Accounting Firm]

Re: [Name of Client] [and Subsidiaries]

Dear Sirs:

By letter date [insert date of request] Mr. [insert name and title of officer signing request] of [insert name of client] [(the "Company") or (together with its subsidiaries, the "Company")] has requested us to furnish you with certain information in connection with your examination of the accounts of the Company as at [insert fiscal year-end].

[Insert description of the scope of the lawyer's engagement; the following are sample descriptions:]

While this firm represents the Company on a regular basis, our engagement has been limited to specific matters as to which we were consulted by the Company.

[or]

We call your attention to the fact that this firm

has during the past year represented the Company only in connection with certain [Federal income tax matters] [litigation] [real estate transactions] [describe other specific matters, as appropriate] and has not been engaged for any other purpose.

Subject to the foregoing and to the last paragraph of this letter, we advise you that since [insert date of beginning of fiscal period under audit] we have not been engaged to give substantive attention to, or represent the Company in connection with, [material]" loss contingencies coming within the scope of clause (a) of Paragraph 5 of the Statement of Policy referred to in the last paragraph of this letter, except as follows:

[Describe litigation and claims which fit the foregoing criteria.]

[If the inquiry letter requests information concerning specified unasserted possible claims or assessments and/or contractually assumed obligations:]

With respect to the matters specifically identified in the Company's letter and upon which comment has been specifically requested, as contemplated by clauses (b) or (c) of Paragraph 5 of the ABA Statement of Policy, we advise you, subject to the last paragraph of this letter, as follows:

[Insert information as appropriate]

The information set forth herein is [as of the date of this letter] [as of [insert date], the date on which we commenced our internal review procedures for purposes of preparing this response], except as otherwise noted, and we disclaim any undertaking to advise you of changes which thereafter may be brought to our attention.

[Insert information with respect to outstanding bills for services and disbursements.]

This response is limited by, and in accordance with, the ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information (December 1975); without limiting the generality of the foregoing, the limitations set forth in such Statement on the scope and use of this response (Paragraphs 2 and 7) are specifically incorporated herein by reference, and any description herein of any "loss contingencies" is qualified in its entirety by Paragraph 5 of the Statement and the accompanying Commentary (which is an integral part of the Statement). Consistent with the last sentence of Paragraph 6 of the ABA Statement of Policy and pursuant to the Company's request, this will confirm as correct the Company's understanding as set forth in its audit inquiry letter to us that whenever, in the course of performing legal services for the Company with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, we have formed a professional conclusion that the Company must disclose or consider disclosure concerning such possible claim or assessment, we, as a matter of professional responsibility to the Company, will so advise the Company and will consult with the Company concerning the question of

**** Note:** See Paragraph 3 of the Statement of Policy and the accompanying Commentary for guidance where the response is limited to material items.

such disclosure and the applicable requirements of Statement of Financial Accounting Standards No. 5.* [Describe any other or additional limitation as indicated by Paragraph 4 of the Statement]
Very truly yours,

Illustrative Form of Letter for Use by Inside General Counsel:

[Name and Address of Accounting Firm]
Re: [Name of Company] [and Subsidiaries]
Dear Sirs:

As General Counsel* of [insert name of client] [(the "Company")] [(together with its subsidiaries, the "Company")], I advise you as follows in connection with your examination of the accounts of the Company as at [insert fiscal year-end].

I call your attention to the fact that as General Counsel* for the Company I have general supervision of the Company's legal affairs. [If the general legal supervisory responsibilities of the person signing the letter are limited, set forth here a clear description of those legal matters over which such person exercises general supervision, indicating exceptions to such supervision and situations where primary reliance should be placed on other sources.] In such capacity, I have reviewed litigation and claims threatened or asserted involving the Company and have consulted with outside legal counsel with respect thereto where I have deemed appropriate.

Subject to the foregoing and to the last paragraph of this letter, I advise you that since [insert date of beginning of fiscal period under audit] neither I, nor any of the lawyers over whom I exercise general legal supervision, have given substantive attention to, or represented the Company in connection with, [material]** loss contingencies coming within the scope of clause (a) of Paragraph 5 of the Statement of Policy referred to in the last paragraph of this letter, except as follows:

[Describe litigation and claims which fit the foregoing criteria.]

[If information concerning specified unasserted possible claims or assessments and/or contractually assumed obligations is to be supplied:]

With respect to matters which have been specifically identified as contemplated by clauses (b) or (c) of Paragraph 5 of the ABA Statement of Policy, I advise you, subject to the last paragraph of this letter, as follows:

[Insert information as appropriate]

The information set forth herein is [as of the date of this letter] as of [insert date], the date on which we commenced our internal review procedures for purposes of preparing this response], except as otherwise noted, and I disclaim any

undertaking to advise you of changes which thereafter may be brought to my attention or to the attention of the lawyers over whom I exercise general legal supervision.

This response is limited by, and in accordance with, the ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information (December 1975); without limiting the generality of the foregoing, the limitations set forth in such Statement on the scope and use of this response (Paragraphs 2 and 7) are specifically incorporated herein by reference, and any description herein of any "loss contingencies" is qualified in its entirety by

Paragraph 5 of the Statement and the accompanying Commentary (which is an integral part of the Statement). Consistent with the last sentence of Paragraph 6 of the ABA Statement of Policy, this will confirm as correct the Company's understanding that whenever, in the course of performing legal services for the Company with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, I have formed a professional conclusion that the Company must disclose or consider disclosure concerning such possible claim or assessment, I, as a matter of professional responsibility to the Company, will so advise the Company and will consult with the Company concerning the question of such disclosure and the applicable requirements of Statement of Financial Accounting Standards No. 5.* [Describe any other or additional limitation as indicated by Paragraph 4 of the Statement.]

Very truly yours,

A71.

EXHIBIT B: REPORT OF THE SUBCOMMITTEE ON AUDIT INQUIRY RESPONSES

Because of a recent court case and other judicial decisions involving lawyers' responses to auditors' requests for information, an area of uncertainty or concern has been brought to the Subcommittee's attention and is the subject of the following comment:

This Committee's report does not modify the ABA Statement of Policy, nor does it constitute an interpretation thereof. The Preamble to the ABA Statement of Policy states as follows:

Both the Code of Professional Responsibility and the cases applying the evidentiary privilege recognize that the privilege against disclosure can be knowingly and voluntarily waived by the client. It is equally clear that disclosure to a third party may result in loss of the "confidentiality" essential to maintain the privilege. Disclosure to a third party of the lawyer-client communication on a particular subject may also destroy the privilege as to other communications on

that subject. Thus, the mere disclosure by the lawyer to the outside auditor, with due client consent, of the substance of communications between the lawyer and client may significantly impair the client's ability in other contexts to maintain the confidentiality of such communications.

Under the circumstances a policy of audit procedure which requires clients to give consent and authorize lawyers to respond to general inquiries and disclose information to auditors concerning matters which have been communicated in confidence is essentially destructive of free and open communication and early consultation between lawyer and client. The institution of such a policy would inevitably discourage management from discussing potential legal problems with counsel for fear that such discussion might become public and precipitate a loss to or possible liability of the business enterprise and its stockholders that might otherwise never materialize.

It is also recognized that our legal, political, and economic systems depend to an important extent on public confidence in published financial statements. To meet this need the accounting profession must adopt and adhere to standards and procedures that will command confidence in the auditing process. It is not, however, believed necessary, or sound public policy, to intrude upon the confidentiality of the lawyer-client relationship in order to command such confidence. On the contrary, the objective of fair disclosure in financial statements is more likely to be better served by maintaining the integrity of the confidential relationship between lawyer and client, thereby strengthening corporate management's confidence in counsel and to act in accordance with counsel's advice.

Paragraph 1 of the ABA Statement of Policy provides as follows:

1. *Client Consent to Response.* The lawyer may properly respond to the auditor's requests for information concerning loss contingencies (the term and concept established by Statement of Financial Accounting Standards No. 5, promulgated by the Financial Accounting Standards Board in March 1975 and discussed in Paragraph 5.1 of the accompanying commentary), to the extent hereinafter set forth, subject to the following:

- a. Assuming that the client's initial letter requesting the lawyer to provide information to the auditor is signed by an agent of the client having apparent authority to make such a request, the lawyer may provide to the auditor information requested, without further consent, unless such information discloses a confidence or a secret or requires an evaluation of a claim.
- b. In the normal case, the initial request letter does not provide the necessary consent to the disclosure of a confidence or secret or to the evaluation of a claim since that consent may only be given after full disclosure to the client of the legal consequences of such action.
- c. Lawyers should bear in mind, in evaluating claims, that an adverse party may assert that any evaluation of potential liability is an admission.
- d. In securing the client's consent to the disclosure

* In July 2009, FASB issued FASB ASC as authoritative. FASB ASC is now the source of authoritative U.S. accounting and reporting standards for nongovernmental entities, in addition to guidance issued by the SEC. As of July 1, 2009, all other nongrandfathered, non-SEC accounting literature not included in FASB ASC became nonauthoritative. FASB Statement No. 5 has been codified as FASB ASC 450.

It may be appropriate in some cases for the response to be given by inside counsel other than inside general counsel, in which event this letter should be appropriately modified.

** Note: See Paragraph 3 of the Statement of Policy and the accompanying Commentary for guidance where the response is limited to material items.

* In July 2009, FASB issued FASB ASC as authoritative. FASB ASC is now the source of authoritative U.S. accounting and reporting standards for nongovernmental entities, in addition to guidance issued by the SEC. As of July 1, 2009, all other nongrandfathered, non-SEC accounting literature not included in FASB ASC became nonauthoritative. FASB Statement No. 5 has been codified as FASB ASC 450.

1. Excerpted from "Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information," *The Business Lawyer* 31, no. 3 (1976). Reprinted by permission of the American Bar Association.

of confidences or secrets, or the evaluation of claims, the lawyer may wish to have a draft of his letter reviewed and approved by the client before releasing it to the auditor; in such cases, additional explanation would in all probability be necessary so that the legal consequences of the consent are fully disclosed to the client.

In order to preserve explicitly the evidentiary privileges, some lawyers have suggested that clients include language in the following or substantially similar form:

We do not intend that either our request to you to provide information to our auditor or your response to our auditor should be construed in any way to constitute a waiver of the attorney-client privilege or the attorney work-product privilege.

If client's request letter does not contain language similar to that in the preceding paragraph, the lawyer's statement that the client has so advised him or her may be based upon the fact that the client has in fact so advised the lawyer, in writing or orally, in other communications or in discussions.

For the same reason, the response letter from some lawyers also includes language in the following or substantially similar form:

The Company [OR OTHER DEFINED TERM] has advised us that, by making the request set forth in its letter to us, the Company [OR OTHER DEFINED TERM] does not intend to waive the attorney-client privilege with respect to any information which the Company [OR OTHER DEFINED TERM] has furnished to us. Moreover, please be advised that our response to you should not be construed in any way to constitute a waiver of the protection of the attorney work-product privilege with respect to any of our files involving the Company [OR OTHER DEFINED TERM].

We believe that language similar to the foregoing in letters of the client or the lawyer simply makes explicit what has always been implicit, namely, it expressly states clearly that neither the client nor the lawyer intended a waiver. It follows that non-inclusion of either or both of the foregoing statements by the client or the lawyer in their respective letters at any time in the past or the future would not constitute an expression of intent to waive the privileges.

On the other hand, the inclusion of such language does not necessarily assure the client that, depending on the facts and circumstances, a waiver may not be found by a court of law to have occurred.

We do not believe that the foregoing types of inclusions cause a negative impact upon the public policy considerations described in the Preamble to the ABA Statement of Policy nor do they intrude upon the arrangements between the legal profession and the accounting profession contemplated by the ABA Statement of Policy. Moreover, we do not believe that such language interferes in any way with the standards and procedures of the accounting profession in the auditing process nor should it be construed as a limitation upon the lawyer's reply to the

auditors. We have been informed that the Auditing Standards Board of the AICPA has adopted an interpretation of SAS 12 recognizing the propriety of these statements.

Lawyers, in any case, should be encouraged to have their draft letters to auditors reviewed and approved by the client before releasing them to the auditors and may wish to explain to the client the legal consequences of the client's consent to lawyer's response as contemplated by subparagraph 1(d) of the Statement of Policy.

A72.

EXHIBIT C: COMPARISON OF STATEMENT ON AUDITING STANDARDS AUDIT EVIDENCE—SPECIFIC CONSIDERATIONS FOR SELECTED ITEMS WITH INTERNATIONAL STANDARD ON AUDITING 501, AUDIT EVIDENCE—SPECIFIC CONSIDERATIONS FOR SELECTED ITEMS

This analysis was prepared by the Audit and Attest Standards staff to highlight substantive differences between Statement on Auditing Standards (SAS) *Audit Evidence—Specific Considerations for Selected Items* and International Standard on Auditing (ISA) 501, *Audit Evidence—Specific Considerations for Selected Items*, and the rationale therefore. This analysis is not authoritative and is prepared for informational purposes only. It has not been acted on or reviewed by the Auditing Standards Board (ASB).

The ASB has made various changes to the language throughout the SAS *Audit Evidence—Specific Considerations for Selected Items*, in comparison with ISA 501, *Audit Evidence—Specific Considerations for Selected Items*. Such changes have been made to use terms applicable in the United States and to make the SAS easier to read and apply. The ASB believes that such changes will not create differences between the application of ISA 501 and the application of the SAS.

Extant AU section 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments* (AICPA, *Professional Standards*, vol. 1), historically has been closely linked to Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 450, *Contingencies*. In addition, the audit inquiry letters required under extant AU section 337 have been subjected to the limitations of the 1975 agreement between the AICPA and the American Bar Association (ABA treaty). Consequently, extant AU section 337 addresses (a) audit procedures to test the entity's compliance with accounting for loss contingencies arising from legal exposure and (b) drafting of audit inquiry letters that conform to the format agreed upon for such letters in terms of the ABA treaty. Therefore, the ASB decided that it would be appropriate to retain such content in the SAS because it is particular to the U.S. environment and continues to

be relevant in practice.

As part of this project, the ASB considered the disposition of AU section 332, *Auditing Derivatives Estimates, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*, vol. 1). The ASB concluded, upon analysis of AU section 332, that much of the material in the extant standard is best addressed through interpretative guidance in the Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*. However, a few requirements in extant AU section 332 exist that the ASB concluded were not addressed by other requirements in the clarified standards, primarily those relating to auditing the valuation assertion. The ASB concluded that it was appropriate to retain these requirements and, therefore, decided to include them and related application guidance in this SAS. ISA 501 does not include similar requirements.

The ASB decided to include paragraph 19 to require auditors to seek direct communication with the entity's in-house legal counsel in cases in which the entity's in-house legal counsel has the responsibility for the entity's litigation, claims, and assessments. The inclusion of this requirement was indirectly in response to comments received during the exposure of the proposed SAS. The requirement to seek direct communication with in-house legal counsel is also consistent with existing U.S. practice.

The ASB decided to include paragraph 20 to require auditors to document the basis for any determination not to seek direct communication with the entity's external legal counsel.

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THE LAST WORD

I was born in Zambia, raised in neighboring Zimbabwe, and came to the United States in 1995, just before my 21st birthday.

Given that I did other things before jumping into the CPA environment and getting that designation, I am your "reverse" CPA. Accounting, however, must always have been on my mind, because I have always had a certain fascination with numbers. My first inclination was to go into banking. So, beginning in 1996, I worked in banking for a number of years, ending as a branch manager.

I left banking because a friend and I saw an opportunity. In 1998, people in general had very few choices to get news, other than traditional sources. We co-founded a news service to provide an alternative place where people could get real-time information about the Middle East and North Africa (MENA) region. We worked with different newspapers, freelancers, and exclusive writers in the MENA region to acquire news localized to individual countries and sell it to businesses and news outlets, such as Reuters. Our business was going well and growing; we wanted to expand our reach and product line by bringing on more people to write. My role in our company was that of vice chairman of the board and CFO. We were in the process of talking with various investors for expansion when 9/11 happened. With that tragedy, our ability to get the capital needed was impeded. We ended up selling assets and closing our doors.

I studied a year in college in Africa in 1994 then continued earning a number of college credits while working in banking in the U.S. from 1995 to 1997. After closing our news service, I decided to return to school. In January 2002, I enrolled in North Carolina Wesleyan College as a full-time student (while working full time, also) and declared accounting as a major. By January of 2003, I

was studying for the CPA exam, which I took in May and was able to pass all four parts in the same sitting. I was licensed in September 2003.

My career as a CPA has been fantastic! At the time I got my license, I was working as a budget analyst for a nonprofit in North Carolina that does reproductive health training in developing countries. My role was managing an annual budget of \$17 million for activities in about 30 different countries. I left that company after three years to work for a nonprofit that supports community economic development statewide. I was vice president for financial analysis and later CFO. In 2007, I felt the entrepreneurial spirit again and stepped out on my own. My last employer—the nonprofit where I was CFO—became my firm's first major client.

Ever since becoming a CPA I have tried to participate as an active professional. Many young professionals think, "I'll just do my work," but there needs to be an aspect that you are able to give back to the profession by participating actively.

In my state association I've been on several committees, such as the Not-For-Profit and the Minority Action committees. I was chair of the Young CPA Cabinet in 2005–2006. I've also been on the Speakers Bureau, which allows me to get the message out to young people about how dynamic our profession is. I'm also active in the AICPA. I was fortunate to be selected for the inaugural Leadership Academy, and I am on the Professional Liability Insurance Program Committee, as well as a member of Council. I am also active in the local community where I sit on the board for two organizations—a community health entity and a conservation entity. I am also active in my church, where I am the finance officer.

I like working with young people. Over the past seven years I have maintained contact with several students. Most of these relationships arose from a visit to their school or a presentation made concerning the value of the CPA credential. One of the longest mentoring relationships I've had spans four years with a gentleman who was in college when we met. He has now passed the exam and is working in industry.

We are the sum total of our experiences, and I know this is true for me. I really believe everything I have participated in has helped to bring me to where I am now. This is an incredible place to be.

—As told to Linda Segall, linda@segallenterprises.com, a freelance writer from Jacksonville, Fla.

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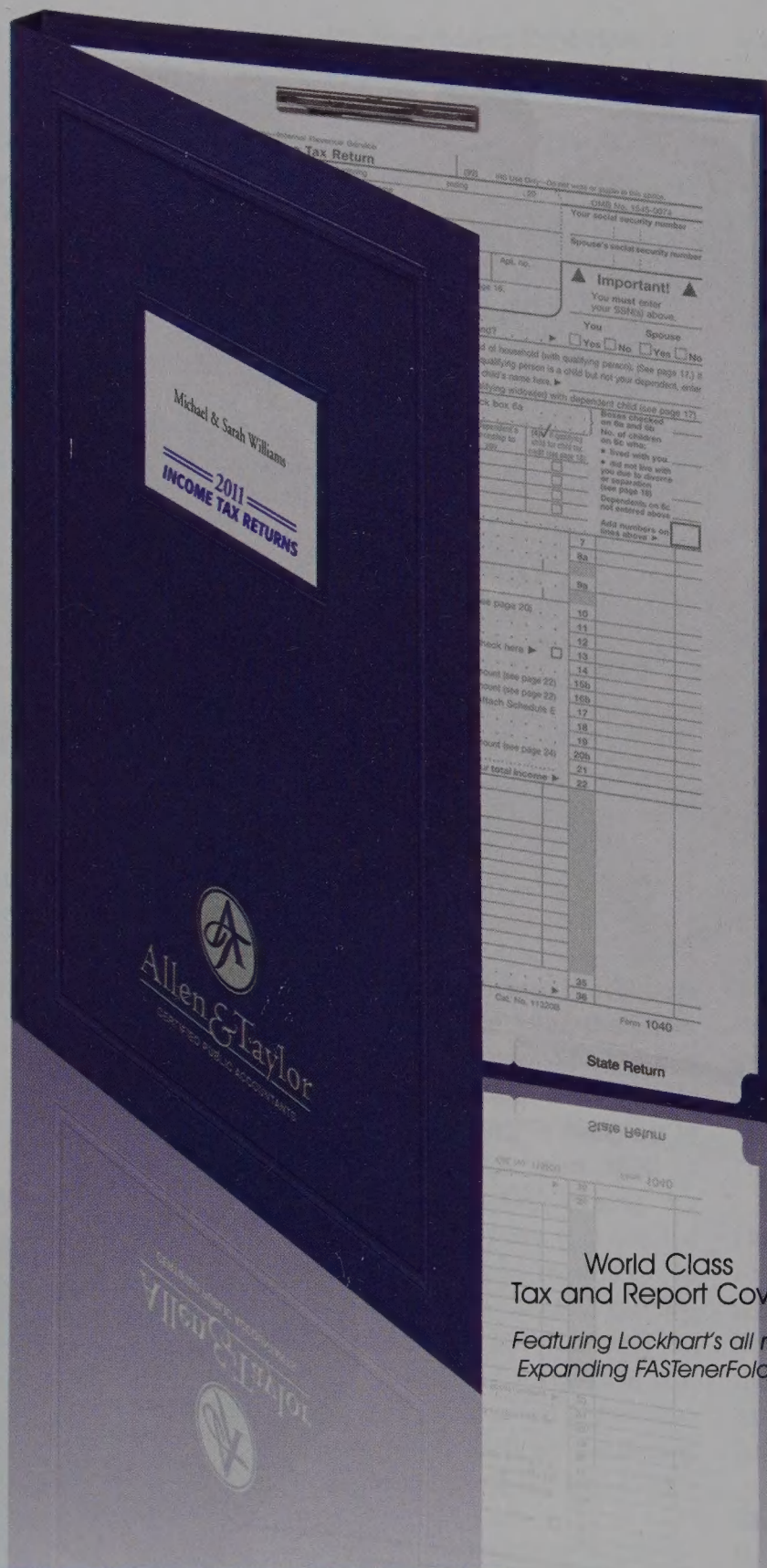
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